Fiscal Policy In the Smaller Industrial Countries, 1972–82

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Preface

This study was undertaken to provide information and analyses of developments in the public finances of the smaller industrial countries over the decade 1972–82. It also reflects an evolving pattern in the Fiscal Affairs Department of the International Monetary Fund of following fiscal developments in groups of member countries. At the same time, the study is intended to partially meet recent requests of the Executive Board for international comparison and analysis of various aspects of fiscal developments and policies. The choice of countries was made on the basis of two criteria: first, the availability of statistical and other sources suitable for comparative purposes; and second, the considerable gap in the literature on comparative fiscal policies in these countries, much more so than in the major industrial countries—the only other homogeneous group of member countries that meets the first criterion.

Owing to lack of comparable statistical data, the study does not go beyond 1982, and in one instance, not beyond 1981—the last years for which such data were available when the study was completed. Although inclusion of a more recent period would have been desirable, its omission has little effect on this study, as it focuses on institutional arrangements and fiscal developments over a longer period of time for the purpose of revealing features that might enhance knowledge and understanding of various aspects of public finances and fiscal policy. Moreover, the study covers the most turbulent years of the postwar period for the world economy: a period that posed an exceptionally strong challenge to fiscal policy. In considering the likely path of fiscal policy in the future, limited account is taken of the events that occurred in 1983 and 1984. It is clear, however, that in this period the orientation of fiscal policy underwent changes in some of these countries. Therefore, to avoid giving an inaccurate impression of the current situation, footnotes at the end of the relevant country sections briefly indicate the general direction of such changes.

Various Fund documents and Organization for Economic Cooperation and Development (OECD) country surveys are the basic sources used in the analysis. Other sources are quoted separately as appropri-

ate. Statistical data on consolidated central government finances are derived from the 1983 and 1984 *Government Finance Statistics (GFS) Yearbooks*, which provide statistics that are consistent over time and comparable across countries. *GFS* data may differ from those conventionally used by national authorities, owing to different conceptual interpretation. According to the *GFS* definition, consolidated central government includes social security funds and may cover other entities that in some countries are not usually attributed to central government. Also, net lending is grouped with expenditure in *GFS*. Ratios of revenue and expenditure to gross domestic product (GDP), for example, may for these reasons tend to be larger than those derived from national sources, and measurements of fiscal balances may also differ. The source for GDP statistics is the 1984 *International Financial Statistics (IFS)* Yearbook and subsequent updates. For countries whose fiscal years do not coincide with calendar years, the GDP data have been adjusted to fiscal years. Data on selected economic indicators presented at the end of each country section are taken from *OECD Economic Outlook*, December 1984, and national sources as indicated.

The study is divided into two parts. Part I is a comparative analysis, and Part II deals with institutional arrangements and fiscal developments in individual countries. Part I is organized as follows. Chapter 1 sets forth some major economic characteristics of this group of countries, their implications for the pursuit of fiscal policy, and the role played in that respect by the central government. The chapter concludes by reviewing the main aims of fiscal policy over the period. Chapter 2 accounts for the growth of expenditure and revenue and the implications for the fiscal balance and debt accumulation. Chapter 3 provides a broad account of fiscal policies pursued by these countries over the period and examines how changes in economic circumstances, like the impact of the two oil crises, affected the policy stance. Chapter 4 considers major obstacles encountered by most countries in the group in their endeavors to bring about targeted fiscal adjustments; and Chapter 5 goes on to analyze implications of past fiscal developments and policies for overall economic performance. Chapter 6 summarizes the main findings and draws some conclusions. The structure of the study of developments in individual countries is accounted for in the introduction to Part II.

For assistance in writing this book, the author is indebted to many colleagues at the International Monetary Fund. Particular thanks are due to Vito Tanzi, Director of the IMF Fiscal Affairs Department,

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The views expressed here are those of the author and should not be ascribed to the International Monetary Fund.

PART I

A COMPARATIVE ANALYSIS

1

The Smaller Industrial Countries

SOME ECONOMIC CHARACTERISTICS

A revised classification of countries was adopted by the Fund in December 1979 for the purpose of statistical presentation and economic analysis and was first used in the March 1980 issue of *International Financial Statistics* (*IFS*). Subsequently, this classification was used in other Fund documents such as the *Annual Report* and the *World Economic Outlook*. The countries included in the present study belong to the subgroup of industrial countries identified as the smaller industrial countries, or other industrial countries, as distinct from the seven major industrial countries. They include Australia, Austria, Belgium, Denmark, Finland, Iceland, Ireland, Luxembourg, the Netherlands, New Zealand, Norway, Spain, and Sweden. Switzerland, which also belongs to this group of countries, is not a member of the Fund and, owing to a lack of satisfactory background information, was not included.

The smaller industrial countries share certain economic features, and some of these have an important bearing on the conduct of fiscal policy. Although they are small in population size and economic weight compared with the major industrial countries, their stage of industrial development is advanced by any standard according to which the word "industrial" is taken to imply "the predominance of relatively sophisticated technology throughout the country's economy," as defined in the relevant Fund document. In other respects the countries differ substantially among themselves. Spain, for example, has a population of 38 million; Australia and the Netherlands follow with 15 million and 14 million; Iceland and Luxembourg have the smallest populations of 231,000 and 366,000, respectively (Table 1.1). Population density also differs markedly. The Netherlands, with 346 inhabitants per square

Table 1.1. Smaller Industrial Countries: Selected Basic Statistics

	Population (thousands)[1]	Inhabitants Per Sq. Km.[1]	GDP Per Capita (U.S. dollars)[2]	Foreign Trade as a Percentage of GDP[3]	
				Exports of goods	Imports of goods
Australia	14,293	2	10,763	14.0	15.3
Austria	7,508	89	8,842	23.6	29.1
Belgium	9,852	323	9,651	60.6[4]	66.9[4]
Denmark	5,122	119	11,350	27.2	29.9
Finland	4,800	14	10,328	26.9	27.6
Iceland	231	2	12,791	26.3	36.5
Ireland	3,443	49	4,855	46.2	55.3
Luxembourg	366	141	10,566	—	—
Netherlands	14,247	346	9,861	48.3	45.6
New Zealand	3,176	12	7,957	23.3[5]	23.5[5]
Norway	4,100	13	13,937	31.3	27.6
Spain	37,654	75	4,938	11.5	17.7
Sweden	8,324	19	13,505	27.3	28.2

Source: Organization for Economic Cooperation and Development, *Economic Surveys*.
[1] Mid-1981.
[2] 1981 at current prices and exchange rates.
[3] 1982.
[4] Including Luxembourg.
[5] 1980.

kilometer, ranks among the most densely populated countries in the world; while Australia and Iceland, with only 2 inhabitants per square kilometer, are among the most sparsely populated countries. It might be argued that a priori this last feature implies special fiscal burdens because of the cost of providing adequate infrastructure and other services in conditions of limited economies of scale. However, the rather scanty studies available on this subject are inconclusive, and the statistical evidence does not seem to support this argument, except perhaps in the case of national defense.[1] Moreover, in the two countries concerned, evidence does not seem to support the argument either, as their expenditure/gross domestic product (GDP) ratios are among the lowest in the group and their infrastructure and public services are adequate. Perhaps the relatively high per capita income of these two countries explains part of this phenomenon.

[1] See, for example, E.A.G. Robinson, ed., *Economic Consequences of the Size of Nations* (London: Macmillan & Co., Ltd., 1960), pp. xxi–xxii.

A corollary of an advanced stage of industrial development is a high standard of living of the population. Per capita GDP figures indicate that by and large the smaller industrial countries rank high on this scale and exhibit per capita income in the neighborhood of or exceeding US$10,000, based on 1981 statistics. Only in Ireland and Spain is per capita income substantially lower, around US$5,000 in each country.

For this study, the most significant economic characteristic of these countries is the openness of their economies. Measured by the commodity export and import ratios to GDP, the Benelux countries and Ireland have the largest foreign trade sectors of nearly 50 percent or over. In most other countries in the group, foreign trade amounts to more than 25 percent of GDP, and only in Australia and Spain is this ratio considerably lower, some 15 percent on average in each country. For some countries, the criterion of openness is substantially enlarged when services are included. This applies, in particular, to Austria and Spain, for tourism; Iceland, for air transport; Luxembourg, for international banking; and Norway, for shipping. This economic openness made the smaller industrial countries especially vulnerable to external impulses caused by the oil crises of 1973–74 and 1979–80 and the ensuing world recession. Another implication of large external sectors is that the effects of measures designed to stimulate activity and employment tended to be weakened by leakages into imports. The small values of fiscal multipliers thus restricted the effectiveness of fiscal measures and frequently aggravated the balance of payments problems most of the countries had to cope with over the period. These issues are considered further in Chapter 3.

ROLE OF CENTRAL GOVERNMENT

An analysis of fiscal policy should ideally encompass the public sector as a whole, as significant activities are carried out by local governments and in some countries by other public entities. But lack of statistical data prevents any detailed examination of the public sector, so the analysis is confined mostly to the central government. This approach should not be too misleading, because the nature and national character of the central government's activities and the sheer size of its operations within the public sector allow it to dominate fiscal policy. This would appear to be particularly relevant in the context of stabilization policy, an aspect of fiscal policy that assumed a heightened role in most countries during this turbulent period. However, because the role of

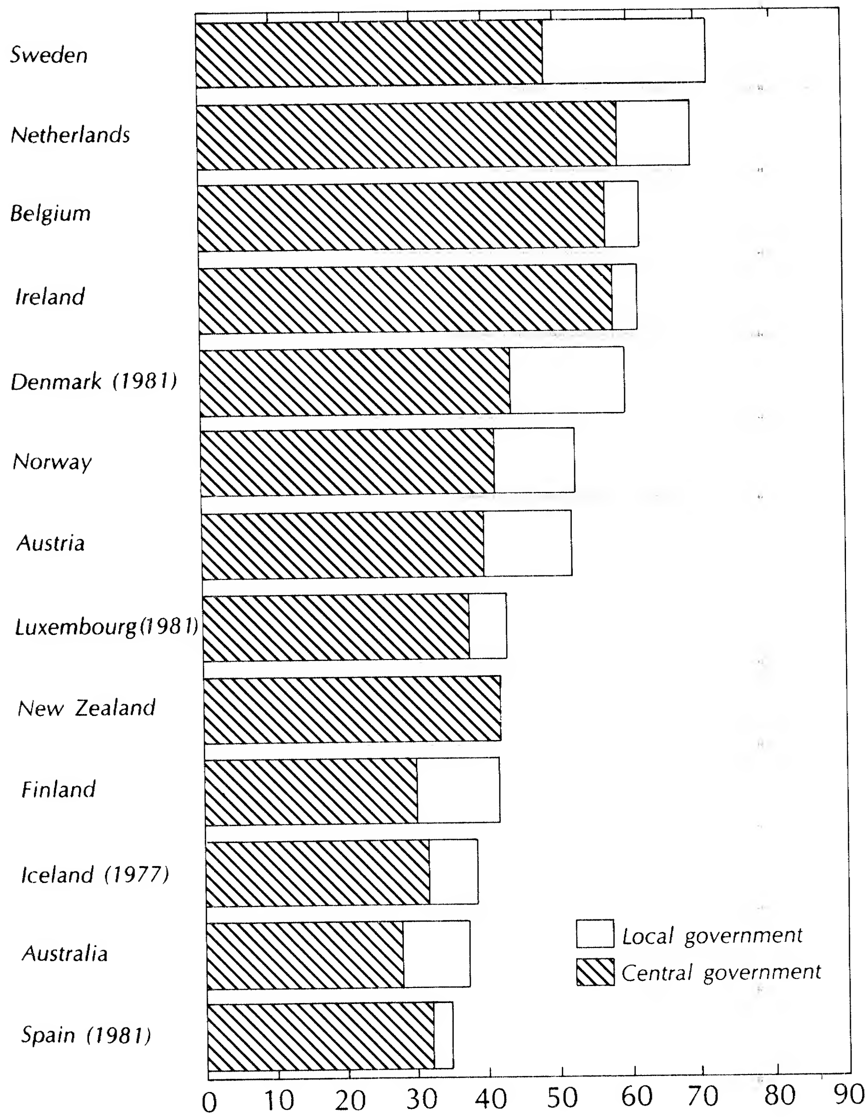
local authorities and other public entities in the pursuit of fiscal policy cannot be totally disregarded, this section considers some of the relevant relationships.

The size of the public sector in relation to total economic activity, and especially the relative size of the central government sector, determines in large measure the framework for using the public finances as a tool of economic management. The higher the ratio of government expenditure to GDP, the greater the leverage of fiscal policy. Chart 1 demonstrates these relationships in each country in 1982 except where otherwise indicated. Sweden has the highest general government expenditure/GDP ratio (71 percent), and Spain, the lowest (35 percent). But when the relative size of the central government is taken into account, the Netherlands has the highest ratio (59 percent), and Australia, the lowest (28 percent).

The chart shows that the relative size of the local government sector differs substantially among these countries. The Nordic countries—with the exception of Iceland—and Austria have the largest local governments in terms of expenditure/GDP ratios, while Spain's local government sector, by comparison, is the smallest. Although there is not, in principle, a causal link between relative size and the financial autonomy of local governments, experience in these countries nonetheless indicates a certain degree of correlation. Where local governments are largest, the degree of financial autonomy tends to be highest. For example, in Denmark, Finland, and Sweden, local governments enjoy a high degree of autonomy, as their ability to raise revenue from major sources such as local income or property taxes demonstrates. The economic significance of the local government sector in these countries has made it necessary to develop procedures that would coordinate fiscal policy with high priority objectives, such as the maintenance of employment, containment of public expenditure growth, and limitation of revenue raising measures that would affect the price level. Such coordination ordinarily takes place through negotiations between central and local authorities. In Denmark these procedures have led to the presentation of an annual public sector budget. Similar arrangements were established in Austria in the early 1970s when local authorities undertook to pursue a restrictive expenditure policy and to refrain from raising fees and charges. Also in Austria, local government shares in federal taxes were temporarily frozen as special deposits in the central bank to be used for countercyclical purposes. In Australia, where the local government sector is relatively large, five-year agreements are

Chart 1. Size of General Government Sector: Expenditure as a Ratio to GDP

(1982 unless otherwise indicated)



Note: Transfers to local governments are counted at the central level. Data on general government for the Netherlands are based on national sources and may not be fully comparable with those for other countries. Data on general government for New Zealand are not available.

made about commonwealth government financial assistance to the states. However, even in countries with large local government sectors, the central government can usually influence their activity through transfers from the budget and control of some of their revenues.

In countries with the smallest local government sectors, the financial autonomy of local authorities tends to be the most restricted. In Iceland, Luxembourg, and Spain, for example, the central government dominates public sector activity and exerts influence on local authorities through cost or revenue sharing arrangements. Local authorities in these countries also have very limited revenue raising and borrowing authority; their dependence on central government transfers and other commitments made each year in the budget is significant. It is also common for the central government in these countries, and indeed in others with larger local government sectors, to command the most productive and elastic revenue sources.

In some countries in the group, local governments are required, in principle, to observe budgetary balance as an operational rule, at least as far as current revenue and expenditure are concerned. Borrowing for investment is frequently controlled or supervised by the central government or by commissions or boards where central government representation is marked as in, for example, Australia, the Netherlands, New Zealand, Norway, and Spain. A balanced local government budget is, however, not a rule without exceptions. In Australia and Belgium, for example, deficits in local government finances have been substantial in recent years. In Belgium the authorities have responded by imposing balanced budgets on the local authorities by law from 1988.

In addition to exerting varying degrees of influence on local government activity, the central government in some countries in the group uses other public entities in the pursuit of fiscal objectives. In Austria, for example, the central government has relied on the nationalized industries to promote the high-priority aim of sustaining employment during recessions; in Norway the state banks play a significant role in financing projects that are specifically conceived as an instrument of employment support, and part of their lending is financed by direct government loans; in Ireland the Government has encouraged capital expenditure by semipublic bodies to sustain employment; and in Spain funds obtained from the banking sector through captive arrangements are channeled to official credit institutions through the budget to finance priority investments in line with official policy. Similar

arrangements outside ordinary budgetary channels have been made in some other countries in the group, although perhaps not to the same degree.

MAIN OBJECTIVES OF FISCAL POLICY

This section provides an overview of major objectives of fiscal policy. These objectives may be taken as fairly representative for the group as a whole over the period covered, although there are differences in degree in individual cases. Measures to attain these objectives and the implications of these measures are dealt with in Chapters 3 and 5.

While in all countries in the group the maintenance of a high level of employment was declared a special aim of economic policy, some placed this objective at the very top of the priority list and kept it there throughout the period. Cases in point are Austria, Luxembourg, New Zealand, and the five Nordic countries. In most instances, fiscal policy played an instrumental role although approaches differed among countries. A notable exception to fiscal policy involvement is Iceland, where other policy approaches sustained a high level of employment.

Inflation remained a cause for concern in most of the countries, and this problem, on occasion, called for action on the fiscal front. Ordinarily such action took the form of a shift in the fiscal stance in a restrictive direction to affect the price level through demand management. However, a number of countries preferred measures that sought to attack inflation through the cost side and, for this purpose, adopted various incomes policy approaches. Countries where the central government has been closely involved in incomes policy include Austria, the Netherlands, and the five Nordic countries. In other countries in the group, attempts at moderating wage settlements through fiscal means were less marked, and in one case, Ireland, the failure of one such attempt led to the abandonment of the approach.

In all countries in the group, the promotion of social welfare schemes was a high-priority objective of fiscal policy. A special impetus emanated from the recession in the mid-1970s when stimulatory measures relied heavily on increases in social expenditure as a means of mitigating the adverse impact on living standards. In some countries, special efforts were made to preserve or improve already high living standards by increasing benefits in real terms and extending their coverage. However, the extent of this policy response differed significantly among the countries. The automatic impact of the recession

on budgetary expenditure was accentuated in some countries by schemes that had been laid down in the more prosperous 1960s, or earlier, when expectations of continuing high rates of economic growth enhanced the generosity of the schemes. In countries where governments were closely involved in incomes policy, fiscal measures designed to dampen wage demands frequently took the form of increased social security benefits.

The social security measures, whether taken independently or in the context of incomes policy, had as an underlying aim the redistribution of income in favor of lower income groups. The objective of income redistribution was given an especially high priority in Spain in the post-1976 period when comprehensive reviews of the tax and social security systems were announced and partially implemented, specifically to favor lower income groups. Other countries took tax measures for the same purpose, often as a fiscal contribution to incomes policy and usually in the form of reductions in personal income tax rates and indexation of tax scales.

The policy response to the first oil crisis and the ensuing world recession was generally to shift the fiscal stance in a highly expansionary direction. This posture was commonly intended to be temporary because the recession was expected to be short lived. However, as the recession persisted, both internal and external imbalances emerged and became a growing cause for concern to the authorities. A fairly general response by the authorities was to give aid in various forms to industries facing structural adjustment problems and grant incentives for transferring resources to sectors exposed to foreign competition. In some cases, aid of this kind was attached to the government's employment policy, in that assistance was made contingent upon the preservation of employment in the industries concerned.

As the period progressed, fiscal imbalances assumed increased proportions, and fiscal policy was increasingly directed at containing these imbalances. This new emphasis implied a restrictive policy posture that attempted to contain or reduce the large-scale absorption of resources by the public sector, which was seen as having an adverse long-term impact on economic performance. This attitude is in vivid contrast to the prevailing view in the early 1970s when public sector expansion was not generally perceived as detrimental to the growth of the economy. On the contrary, in at least two countries in the group, Australia and Luxembourg, the governments declared it a special objective of fiscal policy to enlarge the role of the public sector in the

economy. An increasing number of countries in the group have adopted the approach of setting specific targets to contain or reduce the ratio of certain fiscal aggregates to GDP over a given period of time. Most usual are targets relating to the deficit/GDP ratio, but similar targets for total revenue or expenditure, or a combination of two or all three, have been officially announced in some countries.

As will be demonstrated in the following chapter, the growing efforts to reduce fiscal imbalances met with only limited success. The various potential reasons for this failure will be considered in Chapter 4.

2

Growth of the Government Sector

The sharp increase in the proportion of community output appropriated by the state is among the most outstanding changes in industrial economies during this century. Studies of this phenomenon have revealed a certain historical pattern in which periods of social upheavals, such as two world wars and the depression of the 1930s, were associated with abrupt upward shifts in the public expenditure/GDP ratio. Although the expenditure level generally subsided after the upheavals, it came to rest at a level appreciably above the one prevailing before the disturbance. This pattern has been explained in terms of a displacement effect hypothesis advanced in a study of long-term public expenditure growth in the United Kingdom.[1] In essence, the hypothesis emphasizes the role of social disturbances in changing taxpayers' perceptions of tolerable tax burdens. Relaxation of these financial stringencies enables governments that are under constant pressure for increased public spending to maintain expenditure after the disturbance at a level substantially above the earlier level. The Peacock-Wiseman study was followed by a number of similar studies in other countries that appeared to lend support to this hypothesis.

Although the severity of the two oil crises in the 1970s and the associated worldwide recession hardly matches that of the social upheavals earlier in the century, the explosive growth of expenditure/GDP ratios in some of the smaller industrial countries during the 1970s and early 1980s falls into a pattern that might conform to the displacement effect hypothesis. However, the role of tax burden perception as a check on expenditure growth evidently lost much of its perceived

[1] Alan T. Peacock and Jack Wiseman, *The Growth of Public Expenditure in the United Kingdom* (Princeton: Princeton University Press, 1961), pp. 24–30.

previous strength, with the result that deficits of an unprecedented magnitude and persistence are now a fairly common fiscal feature. While this line of analysis could prove interesting, it will not be pursued any further, as the focus here is rather on the economic implications of the expansion of the government sector. To set the stage, this chapter accounts for major changes in fiscal aggregates during 1972–82, with emphasis on total change over the period. The time pattern of change in each country is demonstrated in Charts 2, 3, and 4 in this chapter and is discussed in some detail in Part II.

EXPENDITURE

Total expenditure of the consolidated central government rose as a proportion of GDP in all countries in the group over the period covered (Table 2.1 and Chart 2). However, the expansion differed markedly among individual countries. From 1972 to 1982, two countries, Ireland and Belgium, experienced the sharpest increase in this ratio, 21 and 17 percentage points, respectively. Sweden and Denmark followed with over a 13 percentage point rise each, and the Netherlands (1973–82) and Spain (1972–81), with increases of 13 and 12 percentage points, respectively. Countries whose expenditure/GDP ratios expanded between 5 and 11 percentage points over this period are New Zealand, Austria, Iceland, and Finland; Luxembourg's and Australia's shares rose moderately by less than 4 percentage points. The smallest expansion of the government sector took place in Norway, 2½ percentage points over the ten-year period.

Expenditure on goods and services, chiefly wages and salaries, absorbed a declining proportion of budgetary resources over the period in all countries in the group except Iceland where its proportion of total expenditure, as well as its share in GDP, rose substantially[2] (Table 2.2). The ratio of expenditure on goods and services to total expenditure is highest in Spain, at 36 percent, and lowest in the Netherlands and Sweden, at 14 percent.

A comparison of individual categories of expenditure with total expenditure and changes in ratios over time is of limited explanatory value, however, as it essentially reflects different relative sizes of the government sector in the various countries and changes in other expenditure categories in each country. A sounder basis for comparison

[2]The increase resulted in part from a change in definition.

Table 2.1. Total Expenditure as a Percentage of GDP

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Australia	24.6	24.3	24.5	29.4	30.7	29.6	30.4	28.9	28.1	28.1	28.3
Austria	30.1	31.9	32.3	35.5	36.1	35.9	38.8	38.7	38.6	39.7	39.9
Belgium	39.8	39.9	39.6	44.8	46.0	47.7	49.5	50.5	51.3	56.2	56.9
Denmark	32.0	31.0	34.4	35.0	35.2	36.0	37.0	38.1	40.6	43.7	45.2
Finland	25.5	24.5	25.5	30.1	31.1	32.0	30.5	30.0	29.5	29.6	30.6
Iceland	30.5	32.3	33.8	35.9	30.8	31.9	31.6	32.4	30.9	31.9	35.9
Ireland	36.7	37.9	43.9	44.3	45.4	43.7	45.2	47.1	52.0	55.0	57.8
Luxembourg	32.1	29.8	29.0	36.7	36.8	39.4	37.8	38.2	39.3	37.9	35.8
Netherlands	...	46.0	47.3	52.4	52.1	50.3	51.3	52.6	54.3	56.7	58.8
New Zealand	31.0	31.3	35.0	40.2	34.7	38.5	40.8	37.7	38.5	40.5	42.2
Norway	39.4	39.3	39.1	40.7	44.6	45.4	45.6	45.2	43.1	41.0	41.8
Spain	20.5	20.4	21.1	22.7	21.6	24.9	26.0	27.8	29.0	32.3	...
Sweden	35.4	34.2	36.1	36.4	38.7	41.3	44.8	45.7	46.5	48.3	48.9

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

Table 2.2. Expenditure on Goods and Services

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Ratio to GDP											
Australia	6.2	5.9	5.7	6.1	6.0	6.0	6.1	5.8	5.8	5.9	6.1
Austria	9.1	8.2	8.5	9.6	9.8	9.7	10.1	10.0	9.9	10.2	10.3
Belgium	9.9	9.8	9.8	11.1	11.0	11.2	11.5	11.4	11.4	12.0	11.7
Denmark	10.4	8.9	9.7	9.8	9.1	8.8	8.6	8.4	8.7	9.0	9.0
Finland	5.8	5.5	5.4	6.1	6.1	6.0	6.1	5.9	6.0	6.0	6.3
Iceland	9.3	9.5	10.2	10.2	10.0	10.2	11.0	11.1	11.2	11.4	12.0
Ireland	7.4	7.4	8.0	8.7	8.5	8.0	7.9	8.4	9.0	9.6	9.6
Luxembourg	7.3	6.9	6.9	8.3	8.0	8.3	8.2	8.3	8.7	7.4	8.1
Netherlands	. . .	8.0	8.0	8.7	8.5	8.3	8.1	8.4	8.4	8.5	8.5
New Zealand	9.5	9.3	9.2	9.4	8.9	9.4	9.9	9.5	10.4	10.7	10.9
Norway	7.6	7.4	7.3	7.6	7.7	7.6	7.5	7.2	6.9	7.4	7.4
Spain	8.9	9.1	9.1	9.5	9.9	10.5	11.2	10.3	12.2	11.6	. . .
Sweden	7.3	7.3	7.3	7.2	7.0	7.1	7.3	7.4	7.4	7.2	6.8
Share in Total Expenditure											
Australia	25.1	24.1	23.4	20.6	19.5	20.1	20.1	20.0	20.4	21.0	21.7
Austria	30.4	25.8	26.2	27.1	27.1	27.0	26.0	25.8	25.6	25.7	25.9
Belgium	24.9	24.6	24.8	24.7	24.0	23.4	23.2	22.6	22.2	21.4	20.5
Denmark	32.5	28.8	28.1	28.1	25.7	24.4	23.3	22.2	21.3	20.7	20.0
Finland	22.7	22.4	21.2	20.2	19.7	18.9	19.9	19.7	20.5	20.2	20.4
Iceland	30.7	29.3	30.2	28.3	32.4	32.0	34.8	34.1	36.3	35.8	33.4
Ireland	20.1	19.5	18.2	19.6	18.7	18.2	17.5	17.8	17.3	17.5	16.6
Luxembourg	22.7	23.7	23.7	22.7	21.7	21.1	21.8	21.7	22.1	19.6	22.6
Netherlands	. . .	17.4	16.9	16.7	16.3	16.4	15.9	15.9	15.4	14.9	14.5
New Zealand	30.8	29.8	26.2	23.3	25.5	24.5	24.2	25.2	27.1	26.5	25.8
Norway	19.2	18.8	18.8	18.7	17.3	16.8	16.5	16.0	16.0	18.0	17.6
Spain	43.3	44.8	43.0	42.0	45.6	42.1	42.8	37.2	42.1	35.9	. . .
Sweden	20.8	21.2	20.1	19.8	18.2	17.2	16.3	16.2	15.8	14.9	14.0

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

Chart 2. Consolidated Central Government Expenditure
(As a percentage of GDP)

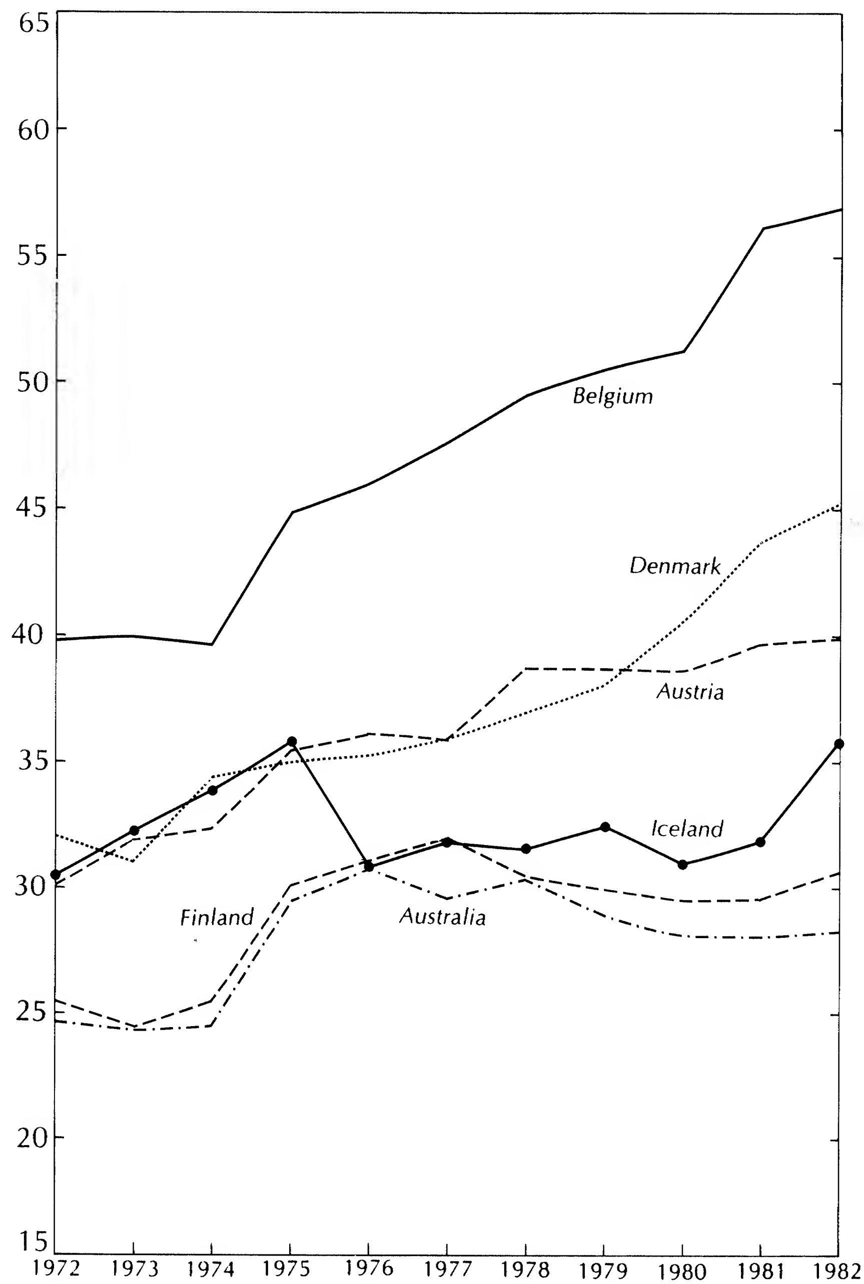
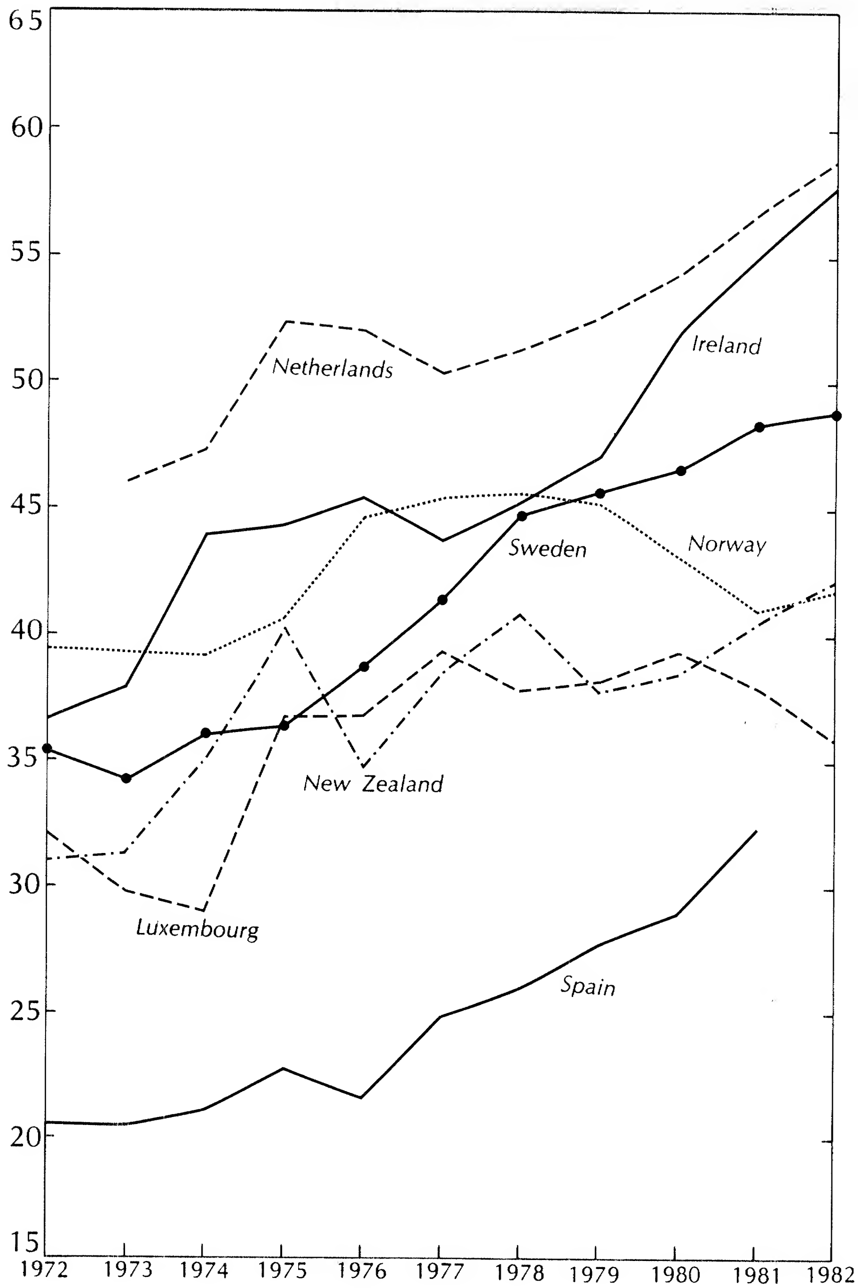


Chart 2 (*continued*). Consolidated Central Government Expenditure
(*As a percentage of GDP*)



is GDP, which is also shown in Table 2.2. This criterion reveals greater similarity and a more stable pattern of change. Spain, Belgium, and Iceland have the highest ratios at about 12 percent, while Australia and Finland exhibit the lowest ratios at around 6 percent. In all countries except Denmark and, to a lesser extent, Norway, Australia, and Sweden, the ratio of expenditure on goods and services to GDP increased over the period; the largest increases were registered in Spain, Ireland, and Iceland, with between 2 and 3 percentage points each. To a certain extent these percentages show an increased government absorption of labor in line with official employment policies, although not in every case. Measures to stimulate employment frequently took other forms, such as increased capital expenditure and lending operations; or, they were carried out in the same form, but by other public entities, such as local governments, as in Denmark and Sweden; in Austria, the nationalized industries received increased central government transfers to compensate for higher costs of creating additional employment.

Interest payments on government debt rose as a proportion of both total expenditure and GDP in all countries (Table 2.3) except Luxembourg, where the government finances registered surpluses for most of the period; and Spain, where continuous surpluses in the 1960s partially absorbed persistent fiscal deficits over the period covered, as did an erosion of outstanding debt brought about by inflation. In five countries—Belgium, Denmark, Ireland, New Zealand, and Sweden—interest payments absorbed a substantial proportion of budgetary resources—between 10 percent and 16 percent of total government expenditure based on 1982 figures; evidence shows that these ratios will increase markedly in the next few years. Interest payments rose abruptly over the period in these countries, although in 1972 the ratios were already quite high in Ireland and New Zealand, at 9½ percent and 7½ percent, respectively. The interest payment ratios are the highest for Belgium and Ireland, at 7½–9 percent of GDP; in the middle range are Denmark, New Zealand, and Sweden, with ratios in the 4–5 percent range. At the lower end are Finland, Luxembourg, and Spain, with ratios of less than 1 percent.

The mounting budgetary burden of interest payments in most countries in the group was mainly caused by large and widening fiscal deficits. Rising interest rates over the period also contributed, and other factors tended to increase the debt-servicing burden. Among these was the growing size of the external component of government debt, which was protected against the erosion of domestic inflation in the long run

Table 2.3. Interest Payments

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Ratio to GDP											
Australia	1.6	1.6	1.4	1.4	1.3	1.7	1.8	1.9	1.9	1.9	1.9
Austria	0.6	0.6	0.6	0.8	1.1	1.3	1.6	1.7	1.8	2.0	2.2
Belgium	2.6	2.6	2.7	2.7	2.9	3.2	3.6	4.1	5.0	6.7	7.7
Denmark	0.4	0.5	0.5	0.5	0.7	1.1	1.3	2.3	2.7	3.8	4.6
Finland	0.5	0.4	0.3	0.3	0.2	0.3	0.4	0.6	0.6	0.7	0.9
Iceland	0.8	1.0	1.1	2.0	1.6	1.7	2.2	2.4	1.8	2.0	2.4
Ireland	3.5	3.6	3.7	4.3	5.0	5.2	5.7	6.1	6.5	7.5	9.1
Luxembourg	1.0	0.8	0.7	0.7	0.7	0.7	0.8	0.8	0.7	0.7	0.7
Netherlands	...	1.3	1.3	1.3	1.5	1.5	1.6	1.7	2.0	2.5	3.2
New Zealand	2.3	2.2	2.2	2.3	2.6	3.0	3.4	3.6	3.6	4.1	4.6
Norway	1.0	1.0	1.1	0.9	1.6	1.9	2.2	2.6	2.7	2.6	2.4
Spain	0.5	0.5	0.4	0.4	0.3	0.4	0.5	0.5	0.5	0.6	...
Sweden	1.0	1.1	1.1	1.3	1.3	1.5	1.8	2.0	2.9	4.3	4.6
Share in Total Expenditure											
Australia	6.6	6.4	5.6	4.9	4.3	5.7	6.0	6.7	6.8	6.9	6.8
Austria	2.1	1.9	1.9	2.2	3.1	3.6	4.1	4.3	4.6	4.9	5.6
Belgium	6.6	6.6	6.9	6.1	6.2	6.7	7.2	8.1	9.8	11.9	13.5
Denmark	1.3	1.5	1.4	1.5	1.9	3.1	3.4	6.1	6.6	8.6	10.1
Finland	1.9	1.7	1.1	0.8	0.8	1.1	1.4	1.9	2.1	2.4	2.9
Iceland	2.6	3.1	3.2	5.6	5.0	5.2	6.9	7.4	5.7	6.2	6.6
Ireland	9.5	9.4	8.5	9.7	11.0	12.0	12.6	12.9	12.6	13.6	15.7
Luxembourg	3.1	2.8	2.4	1.9	1.8	1.9	2.1	2.0	1.9	1.9	2.0
Netherlands	...	2.8	2.7	2.5	2.8	2.9	3.1	3.2	3.7	4.4	5.4
New Zealand	7.6	7.0	6.2	5.7	7.5	7.8	8.3	9.5	9.5	10.1	10.9
Norway	2.5	2.5	2.8	2.3	3.6	4.1	4.8	5.7	6.4	6.3	5.8
Spain	2.3	2.7	2.0	1.7	1.6	1.6	1.7	1.8	1.9	1.7	...
Sweden	2.9	3.1	3.1	3.7	3.3	3.7	4.0	4.4	6.3	9.0	9.5

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

and could have added to the budgetary burden in high inflation countries like Iceland, Ireland, and New Zealand where fiscal deficits were increasingly financed by external sources. Also, in a number of countries, interest rates were determined, for balance of payments reasons, with regard to international rates rather than to domestic market conditions, which tended to put upward pressure on interest rates over the period. However, where financial markets were not well developed and inflation was only partially reflected in interest rates, inflation eroded the stock of outstanding debt in real terms and lessened the budgetary burden of interest payments. Indexation of financial assets, as practiced in Finland in the early part of the period and in Iceland over the whole period, reduced this erosion—but only partially, as not all financial assets were indexed.

Subsidies and other current transfers form the largest expenditure category in all countries in the group. The category includes such items as social security benefits and aid to ailing industries—both of which played a major role in efforts to cushion the recessionary impact—and transfers to other levels of government and to public enterprises. By the end of the period, this category accounted for one half to two thirds of total expenditure in all countries except Spain and Iceland where the ratios were 42 percent and 37 percent, respectively (Table 2.4). Generally, this category increased faster than total expenditure, thus implying a still faster growth in its ratio to GDP. The largest increases in this ratio occurred in Sweden, Ireland, the Netherlands, Denmark, and Belgium; the smallest increases took place in Iceland, Norway, Luxembourg, and Finland. Not unexpectedly, this significant expenditure category was a major determinant of the total expansion of the government sector. A comparison of the relative increases in total expenditure and in subsidies and other current transfers in relation to GDP reveals that in five countries, between 70 percent and 90 percent of the total expansion is accounted for by this category; and in four countries—Australia, Finland, Luxembourg, and Sweden—the category accounts for more than the total expansion, implying that the share of other expenditure categories taken as a whole shrank over the period.

As discussed further in the following two chapters, the abrupt relative increase in subsidies and other current transfers in most countries in the group stems in part from endeavors to mitigate the adverse impact of the recession on living standards and on employment and activity in the sectors hardest hit. The types of expenditure involved are mainly social security benefits, industrial assistance, and, in some cases, transfers to other levels of government and to public enterprises.

Table 2.4. Subsidies and Other Current Transfers

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Ratio to GDP											
Australia	11.7	12.1	12.3	14.5	17.3	17.4	18.5	18.2	17.8	17.8	17.9
Austria	16.8	17.9	18.8	20.8	21.2	21.4	23.3	23.1	22.8	23.3	23.5
Belgium	22.3	23.1	23.0	26.8	27.7	28.8	29.6	30.4	29.6	31.9	31.6
Denmark	18.7	19.3	21.7	22.0	22.6	23.8	24.9	25.4	27.0	28.4	28.9
Finland	13.9	13.5	14.7	17.4	18.4	19.0	18.9	19.0	18.1	18.7	19.5
Iceland	12.1	11.2	12.8	13.0	10.2	10.2	11.0	12.3	11.5	11.7	13.2
Ireland	18.8	19.0	21.3	24.1	24.4	23.4	24.3	25.0	27.4	28.5	30.6
Luxembourg	18.9	17.1	16.7	22.6	22.8	24.8	23.8	23.8	24.7	24.6	22.8
Netherlands	...	30.4	32.9	36.4	36.9	36.1	37.4	37.9	38.2	39.2	41.1
New Zealand	13.4	14.2	15.5	18.1	16.0	18.5	20.5	19.4	19.6	20.8	22.3
Norway	24.4	24.4	24.3	25.0	26.6	27.2	28.5	28.0	26.0	25.6	26.5
Spain	7.2	7.4	7.7	8.3	8.0	9.4	11.2	13.3	12.3	13.6	...
Sweden	17.8	18.2	20.1	20.9	23.3	25.8	28.5	30.1	30.0	31.2	32.3
Share in Total Expenditure											
Australia	47.6	49.8	50.2	49.1	56.2	58.7	61.0	62.8	63.4	63.2	63.2
Austria	55.7	56.2	58.0	58.6	58.6	59.6	60.0	59.7	59.1	58.7	58.9
Belgium	56.0	58.0	57.9	59.9	60.1	60.5	59.7	60.1	57.7	56.7	55.6
Denmark	58.3	62.2	63.1	62.9	64.2	66.3	67.3	66.7	66.7	64.9	64.0
Finland	54.6	55.1	57.8	57.7	59.3	59.5	62.2	63.5	61.5	63.1	63.8
Iceland	39.7	34.6	37.7	36.1	33.2	32.1	34.8	37.9	37.1	36.6	36.9
Ireland	51.2	50.1	48.4	54.3	53.7	53.5	53.6	53.2	52.8	51.8	52.9
Luxembourg	58.9	57.5	57.6	61.4	61.9	63.1	63.0	62.4	62.8	64.8	63.7
Netherlands	...	66.1	69.5	69.5	70.9	71.7	72.9	72.0	70.4	69.1	69.9
New Zealand	43.2	45.3	44.2	44.9	46.0	48.1	50.3	51.5	51.0	51.3	52.9
Norway	61.9	62.2	62.2	61.4	59.6	59.8	62.4	61.9	60.4	62.4	63.4
Spain	35.3	36.3	36.3	36.4	37.0	37.6	42.9	47.8	42.6	41.9	...
Sweden	50.2	53.2	55.6	57.5	60.1	62.4	63.7	65.8	64.5	64.6	66.0

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

As far as social security expenditure is concerned, measures commonly taken over the period include adjustments for inflation or wage increases, often through automatic mechanisms, increases in real benefits and extension of their coverage, and, in some instances, relaxation of qualifying criteria, such as a reduction of the retirement age in Belgium, Denmark, Luxembourg, and Sweden; the introduction of a flexible retirement option in Sweden; and more generous disability schemes in the Netherlands. Demographic factors also contributed to the increase in social security outlays in some countries; the most notable cases are the aging structure of the population, for example, in Belgium, the Netherlands, and Sweden; a rising female participation rate in Denmark and New Zealand; and a reversal of net emigration patterns in Ireland and of migratory flows of the labor force in Spain. A reverse migratory pattern took place in a host country like Luxembourg. Unemployment compensations rose markedly in most countries, and the recessionary conditions also reduced social security contributions from both employers and employees, which in some countries necessitated increased central government grants. In countries with close government involvement in income determination, increases in various social security benefits were often decided in the context of incomes policy.

Most countries in the group engaged in some form of industrial support to aid industries hardest hit by the recession and by structural changes brought about by changed relative prices, cost structures, and demand patterns. In Norway the rapid development of the oil sector accentuated the need for structural adjustment. Generally, the measures taken were selective, depending on the particular circumstances in each case, and were directed at such objectives as the transfer of resources to the export- or import-competing sectors (Denmark, New Zealand, and Sweden) and the preservation of regional balance in terms of employment opportunities (Austria, Finland, and Norway). Only a part of this assistance is reflected in this expenditure category, however, as other measures such as tax incentives and loan finance were frequently involved.

In some countries, a prominent item under this category is transfers to other levels of government and to public enterprises. Increased transfers to other levels of government sometimes stemmed from obligations assumed by the authorities in carrying out tasks in line with official employment policies, as was the case in Denmark and Sweden; in other countries, such as Australia and Spain, growing transfers

reflected official policy to enhance the role of local governments. Similarly, increased transfers to public enterprises in countries such as Austria and Spain were partly the result of the role imposed on the enterprises in pursuing employment and anti-inflation policies, respectively.

Capital expenditure and net lending, taken together, are the expenditure categories most directly involved in policies to stimulate employment and activity; at the same time, they were the type of expenditure most easily reduced when the stance of fiscal policy shifted toward a restrictive direction. For this reason and also because of the nature of expenditure involved, the time pattern of change over the period was rather irregular. By the end of the period, Iceland, Spain, Ireland, Norway, and Finland had devoted relatively the largest portion of budgetary resources to capital expenditure and net lending, ranging from 13 percent in Finland to 23 percent in Iceland (Table 2.5). Ireland and Iceland had the highest ratios to GDP, about 8½ percent each. By contrast, Denmark and Australia had the lowest ratios to total expenditure (6 percent and 8½ percent, respectively), and also the lowest ratios to GDP (2½ percent each). The highest ratios reflect heavy central government involvement in the provision of infrastructure (Luxembourg, Ireland), or a large role played by the government in financial intermediation (Iceland, Norway, Spain). In most countries the ratio of capital expenditure and net lending to GDP declined over the period or remained approximately constant. In three countries, however, this ratio expanded: by 1 percentage point in Belgium, by 1½ percentage points in Ireland, and by almost 3½ percentage points in Spain. As already indicated, this comparison between end-years conceals significant changes within the period, as may be seen in Table 2.5.

REVENUE

Total revenue and grants, expressed as a ratio to GDP, increased in all countries in the group over the period (Table 2.6 and Chart 3). While the rate of increase differed markedly among individual countries, it was much more evenly spread than the rate of growth of expenditure. The largest increases were experienced in Belgium and Ireland, at 9½ and 11½ percentage points, respectively, followed by Sweden and New Zealand, at about 7 percentage points each. The lowest rate of growth occurred in Luxembourg, at just over 1 percentage point; Finland and Denmark were the next lowest, each with about 2 percentage points. A

Table 2.5. Capital Expenditure and Net Lending

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Ratio to GDP											
Australia	5.1	4.8	5.1	7.5	6.1	4.6	3.9	3.0	2.6	2.5	2.3
Austria	3.6	5.1	4.5	4.3	4.0	3.5	3.8	4.0	4.1	4.2	3.8
Belgium	5.0	4.3	4.1	4.2	4.4	4.5	4.9	4.6	5.2	5.6	5.9
Denmark	2.5	2.4	2.5	2.6	2.9	2.2	2.2	1.9	2.1	2.5	2.7
Finland	5.3	5.1	5.1	6.4	6.3	6.6	5.0	4.4	4.7	4.2	4.4
Iceland	8.2	10.6	9.8	10.8	9.0	9.8	7.4	6.7	6.5	6.8	8.3
Ireland	7.0	8.0	10.9	7.3	7.6	7.1	7.4	7.6	9.0	9.4	8.5
Luxembourg	4.9	4.9	4.8	5.1	5.3	5.5	5.0	5.3	5.9	5.7	4.5
Netherlands	...	6.3	5.1	5.9	5.2	4.5	4.2	4.7	5.7	6.6	6.0
New Zealand	5.7	5.6	8.2	10.5	7.3	7.5	7.1	5.2	4.8	4.9	4.4
Norway	6.5	6.5	6.4	7.1	8.7	8.8	7.4	7.4	7.4	5.5	5.2
Spain	3.8	3.4	4.0	4.8	3.4	5.3	4.4	4.4	4.8	7.1	...
Sweden	9.2	7.7	7.6	6.9	7.1	6.9	7.2	6.2	6.2	5.6	5.2
Share in Total Expenditure											
Australia	20.7	19.7	20.8	25.5	20.0	15.4	12.9	10.6	9.3	8.8	8.3
Austria	11.8	16.1	13.8	12.1	11.2	9.9	9.9	10.2	10.7	10.6	9.6
Belgium	12.6	10.9	10.4	9.4	9.6	9.3	9.9	9.2	10.2	10.0	10.4
Denmark	7.9	7.6	7.4	7.5	8.1	6.2	6.0	5.1	5.3	5.7	5.9
Finland	20.8	20.8	19.9	21.3	20.3	20.6	16.5	14.8	16.0	14.3	13.0
Iceland	27.0	33.0	28.9	30.1	29.3	30.7	23.5	20.5	20.9	21.4	23.1
Ireland	19.1	21.0	24.8	16.4	16.6	16.3	16.3	16.1	17.3	17.1	14.7
Luxembourg	15.4	16.6	16.4	13.9	14.5	13.9	13.2	13.9	14.9	15.1	12.7
Netherlands	...	13.7	10.8	11.3	9.9	8.9	8.2	8.9	10.5	11.6	10.2
New Zealand	18.5	17.9	23.4	26.0	21.0	19.6	17.3	13.8	12.4	12.1	10.5
Norway	16.4	16.5	16.3	17.6	19.5	19.3	16.3	16.4	17.3	13.3	13.2
Spain	18.4	16.6	18.8	21.0	15.7	21.2	16.8	15.7	16.5	22.0	...
Sweden	26.1	22.5	21.2	19.0	18.4	16.8	16.1	13.6	13.3	11.5	10.6

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

Table 2.6. Total Revenue as a Percentage of GDP

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Australia	24.3	22.6	24.0	25.4	25.7	26.3	26.7	25.6	26.3	27.3	28.0
Austria	29.9	30.3	30.8	31.5	31.5	32.2	34.7	35.0	35.3	36.8	35.5
Belgium	35.4	36.5	37.4	40.1	40.4	41.7	42.7	42.9	43.6	43.9	44.7
Denmark	34.6	34.5	35.0	33.0	34.9	34.7	36.7	37.4	37.8	37.5	36.9
Finland	26.7	27.3	26.3	27.9	31.0	30.5	28.6	27.4	27.5	28.6	28.6
Iceland	27.9	29.2	29.2	29.7	28.3	27.4	29.0	30.2	29.6	31.1	32.9
Ireland	31.1	31.1	32.0	31.9	35.3	34.3	33.8	35.0	38.6	40.0	42.6
Luxembourg	33.5	32.3	32.9	37.7	37.1	39.9	40.6	38.0	40.0	37.6	34.7
Netherlands	...	46.0	47.3	49.6	49.8	48.4	48.4	48.6	49.9	50.5	51.3
New Zealand	27.2	28.8	30.9	30.0	30.4	33.4	32.3	32.4	32.2	33.3	34.8
Norway	37.9	38.4	37.8	37.5	38.7	38.6	38.8	38.9	41.3	43.1	42.6
Spain	20.0	20.2	19.9	21.0	20.7	22.7	23.7	24.3	24.7	25.3	...
Sweden	34.1	32.8	32.8	33.7	38.3	39.6	39.5	38.1	37.8	38.9	39.0

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

Chart 3. Consolidated Central Government Revenue
(*As a percentage of GDP*)

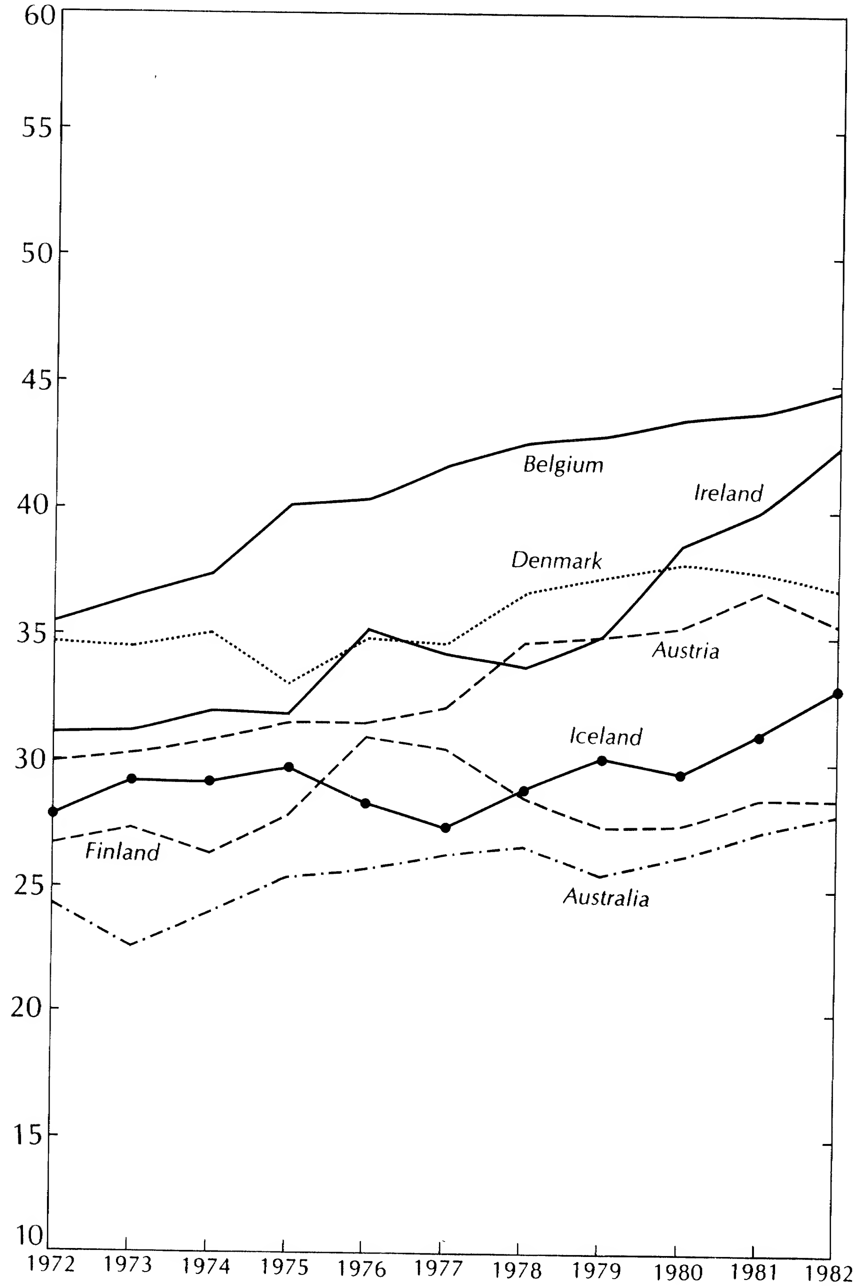
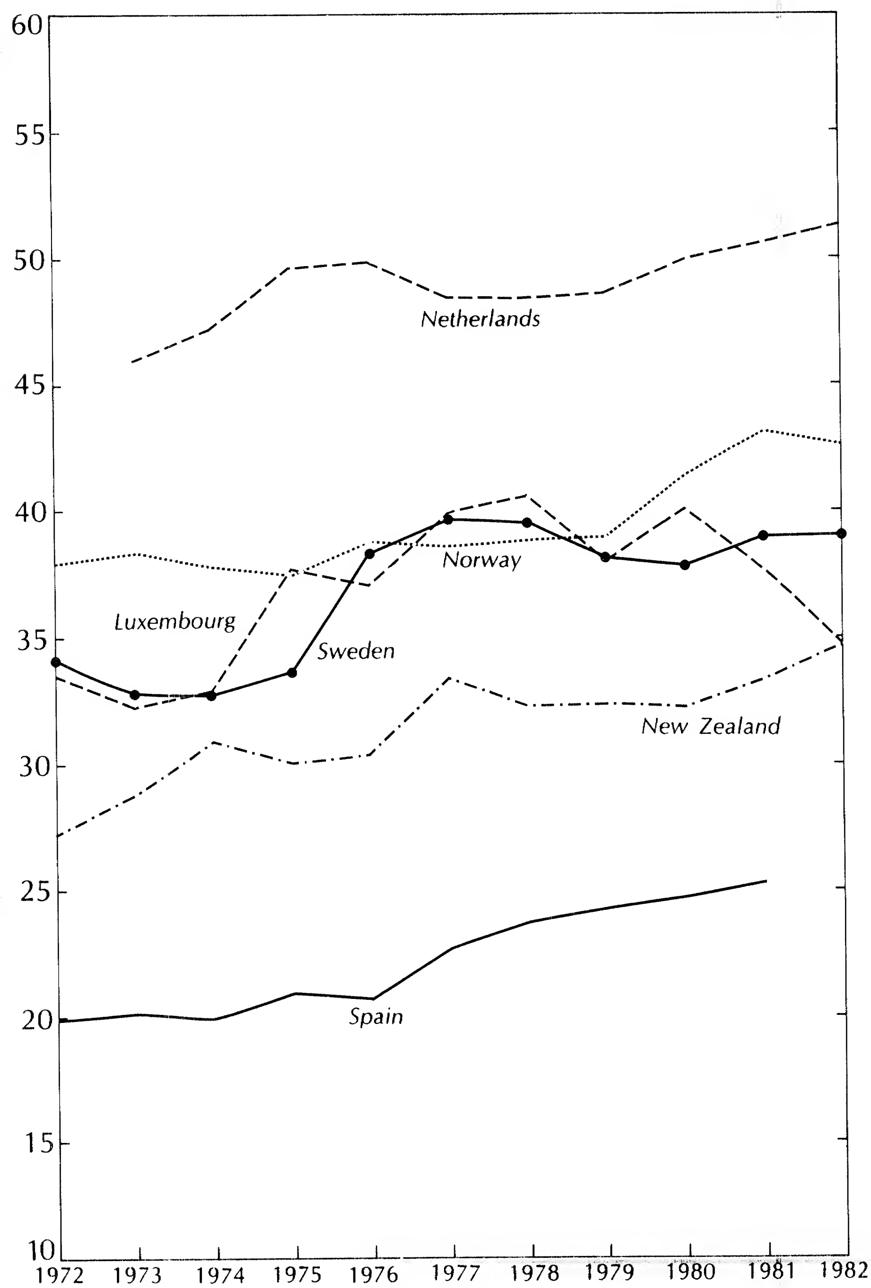


Chart 3 (*continued*). Consolidated Central Government Revenue
(As a percentage of GDP)



comparison of rates of growth of revenue and expenditure reveals that in all countries except Norway expenditure grew faster and, in a few cases, substantially faster than revenue. In Norway revenue grew faster than expenditure between 1972 and 1982 because of rapidly growing oil revenue. Here again, it should be noted that a comparison of end-year ratios in some instances conceals important changes within the period; these are discussed in some detail in Part II of the study. Countries that experienced the greatest disparity in revenue and expenditure growth were Denmark, Ireland, Belgium, the Netherlands, and Sweden, where the difference in terms of ratios to GDP ranged between 6½ and 11 percentage points. This disparity implies a sharp deterioration in the fiscal position in these countries—an aspect that is examined further in the following section.

Income taxes at the central level differ significantly in relative importance among individual countries. Their weight in total revenue is largest in New Zealand and Australia, at 66½ percent and 63½ percent, respectively (Table 2.7). This tax is also highest in relation to GDP in these countries—23 percent in New Zealand and 18 percent in Australia. The high ratios are explained in part by the absence of social security contributions in both countries and the consequent financing of social security expenditure by general taxation. Income tax at the central level is lowest in Iceland and Sweden—11 percent and 15½ percent, respectively, of total revenue and 3½ percent and 6 percent, respectively, of GDP.[3] On the whole, personal income tax is the main source of revenue in this category, except in Norway, where, because of the oil industry, the corporate income tax is the most important. In 9 out of the 13 countries revenue from the income tax grew faster than GDP; the highest rates of growth, as a ratio to GDP, were in New Zealand and Belgium, at 6½ percentage points; and in Ireland and Norway, between 4 and 4½ percentage points. This increase occurred despite a series of reductions over the period as the progressivity of rates secured a still faster growth of revenue yield. However, tax cuts reduced tax elasticities with respect to income to such an extent in Sweden, Iceland, Denmark, and the Netherlands that the ratio fell to a range of 3.1–0.9 percentage points.

Most countries in the group introduced measures over the period to reduce the personal income tax, although the extent of cuts varied

[3]In both countries, and especially in Sweden, the income tax is a major revenue source at the local government level.

Table 2.7. Income Taxes

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Ratio to GDP											
Australia	14.1	13.3	14.6	16.4	16.3	16.8	17.0	15.5	16.0	16.9	17.8
Austria	6.1	6.0	6.6	6.4	6.2	6.4	7.4	7.3	7.3	7.5	7.1
Belgium	11.0	12.0	12.9	14.8	14.5	15.6	16.5	17.0	16.7	16.5	17.6
Denmark	13.6	14.4	15.9	13.4	13.0	12.2	12.7	12.5	12.7	12.7	12.4
Finland	7.9	8.4	8.8	9.1	11.0	9.8	7.7	7.0	7.7	8.6	8.1
Iceland	4.8	5.0	3.6	2.6	2.6	2.2	2.8	3.7	3.2	3.3	3.6
Ireland	8.7	9.0	9.3	9.5	10.6	10.7	10.7	11.2	12.7	13.2	13.2
Luxembourg	11.4	11.9	13.5	14.0	13.6	15.8	16.7	14.6	14.3	13.1	12.1
Netherlands	. . .	14.9	15.3	15.9	15.5	15.0	14.7	14.7	14.8	14.2	14.0
New Zealand	16.7	18.6	21.1	19.7	20.1	22.6	20.9	21.2	21.7	22.2	23.1
Norway	8.2	6.1	6.5	6.2	6.7	6.8	7.0	8.0	11.2	12.3	11.6
Spain	3.2	3.3	3.4	3.8	4.2	4.3	4.9	5.3	5.9	5.2	. . .
Sweden	9.1	7.4	7.1	7.2	9.6	9.3	7.4	7.0	6.8	6.2	6.0
Share in Total Revenue and Grants											
Australia	57.9	58.6	61.1	64.5	63.1	63.6	63.6	60.6	60.8	62.0	63.5
Austria	20.4	19.8	21.4	20.4	19.6	19.8	21.2	20.7	20.6	20.5	20.0
Belgium	31.2	33.0	34.6	36.8	35.8	37.3	38.8	39.6	38.2	37.6	39.4
Denmark	39.3	41.6	45.4	40.6	37.2	35.2	34.6	33.4	33.5	33.7	33.8
Finland	29.4	30.9	33.4	32.7	35.4	32.1	27.0	25.5	28.0	30.0	28.5
Iceland	17.3	17.2	12.2	8.8	9.3	8.0	9.8	12.3	10.7	10.6	11.1
Ireland	28.1	29.0	29.1	29.7	30.1	31.1	31.6	32.1	32.8	32.9	31.0
Luxembourg	33.9	36.7	40.8	37.2	36.6	39.5	41.1	38.5	35.7	34.9	34.9
Netherlands	. . .	32.3	32.3	32.1	31.1	31.0	30.3	30.3	29.7	28.2	27.4
New Zealand	61.2	64.5	68.4	65.6	66.0	67.6	64.7	65.4	67.3	66.8	66.5
Norway	21.7	16.0	17.2	16.5	17.3	17.6	18.0	20.6	27.2	28.5	27.1
Spain	15.8	16.4	17.3	18.1	20.1	18.8	20.8	21.9	23.9	20.5	. . .
Sweden	26.8	22.7	21.6	21.4	25.1	23.5	18.7	18.3	18.1	15.9	15.5

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

according to, inter alia, the rate of inflation. The stated objectives included a reduction or elimination of fiscal drag, which, although in some cases had begun on an ad hoc basis, tended to turn into regular adjustments and, for most countries in the group, ended up as an automatic or a semi-automatic indexation mechanism. In some countries, such as Austria, Denmark, Finland, the Netherlands, Norway, and Sweden, reduction of the tax burden was a stated policy aim, either to reduce disincentives, stimulate private sector demand, or, in certain instances, redistribute income in favor of lower income groups (Spain, Norway). As indicated earlier, a number of countries in the group reduced the personal income tax with the aim of moderating wage settlements.

The corporate income tax was also reduced in several countries to stimulate investment, employment, and activity in the private sector. The measures commonly took the form of rate reductions and increased or accelerated depreciation allowances; and at least in two countries (Denmark and Iceland) depreciation allowances and other deductions were price indexed for corporate income tax purposes.

Social security contributions range from 0 to 47 percent of total revenue in the smaller industrial countries (Table 2.8). These contributions were highest in Spain, at 47 percent, and nonexistent in Australia and New Zealand. In four other countries, the Netherlands, Austria, Sweden, and Belgium, social security contributions range between 30 percent and 40 percent of total revenue, while in Denmark and Iceland they account for only about 3½ percent and 2½ percent of the total; Iceland has no such taxes on employees. In relation to GDP, social security contributions are highest in the Netherlands, at almost 20 percent, followed by Sweden, Belgium, and Austria, at about 13 percent each. The fastest increase in relation to GDP over the 1972–82 period took place in Sweden—some 6 percentage points—followed by Austria—about 3½ percentage points—while Iceland was the only country in which this ratio fell appreciably, by ½ of 1 percentage point, over the period.

In countries where the relevant social security schemes were self-financing in nature, the rapid growth of expenditure pulled up contribution rates and, in some instances, necessitated special transfers to the social security system from the central budget. As the period progressed, however, and higher rates imposed a mounting burden on labor costs, an increasing number of countries implemented a series of reductions in contribution rates. The declared objectives were to

Table 2.8. Social Security Contributions

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Ratio to GDP											
Australia	—	—	—	—	—	—	—	—	—	—	—
Austria	9.0	9.2	9.5	10.3	10.4	10.8	12.2	12.2	12.5	12.9	12.6
Belgium	11.4	11.7	11.9	13.0	13.0	13.2	13.1	13.1	13.2	13.5	13.4
Denmark	1.7	0.6	0.6	0.5	0.5	0.6	0.6	0.7	0.8	1.0	1.3
Finland	2.1	2.4	2.2	2.6	3.0	2.9	2.5	2.7	2.6	2.7	2.8
Iceland	1.3	1.0	1.0	1.2	0.8	1.1	1.2	1.4	1.3	0.8	0.8
Ireland	2.8	3.0	3.7	4.4	4.7	4.5	4.4	4.5	4.9	5.1	5.7
Luxembourg	9.3	8.6	8.8	10.9	11.2	11.6	11.1	10.6	10.4	9.7	8.7
Netherlands	. . .	16.8	17.9	18.4	17.9	17.0	17.3	17.8	18.2	18.8	19.9
New Zealand	—	—	—	—	—	—	—	—	—	—	—
Norway	7.5	10.4	10.2	10.2	9.9	9.9	10.0	9.9	9.1	9.4	9.5
Spain	7.7	8.0	8.2	9.3	8.9	10.7	11.3	11.7	11.6	11.9	. . .
Sweden	7.3	7.2	7.7	9.0	10.2	11.0	12.2	12.3	12.4	13.5	13.2
Share in Total Revenue and Grants											
Australia	—	—	—	—	—	—	—	—	—	—	—
Austria	29.9	30.4	30.9	32.7	33.0	33.7	35.1	34.8	35.2	35.0	35.4
Belgium	32.2	32.1	31.8	32.3	32.2	31.5	30.6	30.6	30.4	30.7	29.9
Denmark	5.0	1.6	1.6	1.7	1.6	1.7	1.6	1.8	2.2	2.6	3.4
Finland	7.7	8.7	8.5	9.4	9.6	9.4	8.9	9.8	9.6	9.5	9.6
Iceland	4.8	3.5	3.5	4.0	3.0	3.8	4.3	4.5	4.2	2.7	2.3
Ireland	8.9	9.6	11.5	13.6	13.2	13.2	12.9	12.9	12.8	12.7	13.3
Luxembourg	27.7	26.6	26.8	29.0	30.3	29.2	27.5	28.0	26.0	25.8	25.2
Netherlands	. . .	36.5	37.8	37.1	36.0	35.2	35.8	36.7	36.4	37.3	38.7
New Zealand	—	—	—	—	—	—	—	—	—	—	—
Norway	19.8	27.2	26.9	27.2	25.5	25.6	25.7	25.5	22.1	21.8	22.3
Spain	38.8	39.7	41.2	44.5	43.0	47.4	47.9	48.2	47.0	47.2	. . .
Sweden	21.5	22.1	23.8	26.7	26.6	27.8	30.9	32.3	32.8	34.7	33.7

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

stimulate activity and employment in the private sector, and in countries like Norway rates were differentiated by regions to promote regional employment policy. In Finland and Norway cuts in contribution rates were at times associated with incomes policy, and in Spain—a country with a serious unemployment problem—the Government committed itself toward the end of the period to reversing the trend of a constantly increasing burden of social security contributions on labor costs. In Sweden where these contributions have grown fastest and are among the highest in terms of ratios to GDP, an increasing proportion has been borne by employers, with the result that the overall ratio of contributions to the total payroll was about 35 percent at the end of the period.

Taxes on goods and services are for a large part value-added or sales taxes and various excise duties and levies. They range between 18 and 48 percent of total revenue and grants, with Spain having the lowest ratio and Finland and Iceland the highest (Table 2.9). In most countries this ratio declined over the period, although it increased in Australia, Denmark, Finland, and Iceland. In Australia the rise was due to a levy on domestic crude oil that was gradually equated with import prices. In the other three countries, value-added or sales taxes were raised to curb private sector demand and to compensate for revenue losses resulting from cuts in the income tax. In terms of GDP ratios, this tax category rose or remained constant in most countries in the group; the largest increases were in Iceland (6 percent) and Denmark (2 percent). In two countries, the ratio declined over the period; in Norway, by 1½ percentage points, and in the Netherlands, by less than 1 percentage point.

Other tax and nontax revenue and grants include payroll taxes, property taxes, taxes on international trade, other taxes, and nontax revenue and grants. This heterogeneous category accounts for 7–39 percent of total revenue and grants (Table 2.10). It is lowest in Belgium and highest in Iceland, where taxes on foreign trade are a significant, albeit declining, revenue source. Expressed as a ratio to GDP, the category ranges between 3 percent in Belgium and 13 percent in Iceland. On the whole, this ratio rose slightly or remained constant for most countries over the period; the most notable exception was the Netherlands, where because of vastly increased revenue from the sale of natural gas, it increased by almost 4 percentage points. Because of their membership in or agreements with the European Communities (EC) or the European Free Trade Association (EFTA), most countries in the group experienced a relative decline in taxes on international trade in relation to GDP over

Table 2.9. Taxes on Goods and Services

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Ratio to GDP											
Australia	5.3	5.0	5.2	4.8	5.3	5.1	5.2	5.7	6.2	6.3	6.1
Austria	8.3	8.9	8.6	8.5	8.7	8.7	8.9	9.0	8.8	9.1	8.9
Belgium	10.2	10.0	9.9	9.8	10.3	10.3	10.4	9.9	10.7	10.7	10.7
Denmark	14.3	14.3	13.4	13.2	14.3	15.3	16.3	16.9	16.7	16.6	16.1
Finland	12.5	12.1	11.1	11.4	11.9	12.8	13.4	13.4	13.3	13.5	13.6
Iceland	9.6	9.4	11.8	13.8	13.6	13.1	13.0	13.1	13.9	14.8	15.5
Ireland	10.1	10.3	9.9	9.5	10.6	10.3	10.1	9.3	9.6	9.5	10.9
Luxembourg	7.0	6.6	5.8	7.5	6.9	6.9	6.9	6.5	7.6	7.3	7.1
Netherlands	...	10.2	9.6	10.0	10.1	10.3	10.4	9.9	10.0	9.6	9.4
New Zealand	5.4	5.2	5.1	5.9	5.5	5.8	6.1	5.9	5.8	6.2	6.7
Norway	17.5	16.8	15.9	16.3	17.1	17.8	17.2	16.3	16.2	16.3	16.1
Spain	4.7	4.7	3.8	3.7	3.3	3.0	3.3	3.3	4.1	4.6	...
Sweden	11.5	11.3	10.8	10.1	10.5	10.9	11.4	11.3	11.0	11.5	11.5
Share in Total Revenue and Grants											
Australia	21.7	21.9	21.5	19.1	20.5	19.5	19.5	22.3	23.4	23.0	22.0
Austria	27.9	29.5	28.1	27.0	27.7	26.9	25.6	25.7	25.0	24.8	25.0
Belgium	28.7	27.5	26.5	24.4	25.4	24.6	24.5	23.2	24.5	24.4	23.9
Denmark	41.4	41.5	38.2	40.0	41.1	44.2	44.3	45.4	44.2	44.3	43.6
Finland	46.8	44.4	42.3	40.8	38.3	42.1	46.7	48.9	48.2	47.2	47.6
Iceland	34.3	32.0	40.3	46.4	48.1	47.9	44.8	43.2	46.9	47.5	47.1
Ireland	32.5	33.0	31.1	29.9	30.1	30.0	29.8	26.6	24.8	23.9	25.6
Luxembourg	21.0	20.4	17.5	19.8	18.6	17.3	17.1	17.2	18.9	19.5	20.3
Netherlands	...	22.2	20.4	20.1	20.4	21.3	21.5	20.5	20.1	19.0	18.3
New Zealand	19.9	18.2	16.6	19.5	18.1	17.4	18.8	18.1	18.0	18.5	19.2
Norway	46.1	43.8	42.1	43.5	44.2	46.1	44.3	41.9	39.3	37.9	37.7
Spain	23.3	23.5	19.3	17.8	15.8	13.3	13.8	13.4	16.7	18.1	...
Sweden	33.8	34.5	32.8	29.9	27.5	27.5	28.8	29.8	29.0	29.6	29.4

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

Table 2.10. Other Tax and Nontax Revenue and Grants

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Ratio to GDP											
Australia	4.9	4.4	4.2	4.2	4.2	4.4	4.5	4.4	4.2	4.1	4.1
Austria	6.5	6.2	6.1	6.3	6.2	6.3	6.3	6.6	6.8	7.2	7.0
Belgium	2.8	2.7	2.7	2.6	2.7	2.7	2.6	2.9	3.0	3.2	3.0
Denmark	4.9	5.3	5.2	5.9	7.0	6.6	7.2	7.3	7.6	7.3	7.1
Finland	4.3	4.4	4.2	4.7	5.2	5.0	5.0	4.3	3.9	3.8	4.1
Iceland	12.2	13.8	12.8	12.1	11.2	11.1	11.9	12.1	11.3	12.2	13.0
Ireland	9.5	8.8	9.1	8.5	9.3	8.8	8.7	9.9	11.4	12.2	12.8
Luxembourg	5.8	5.3	4.9	5.3	5.3	5.6	5.8	6.2	7.8	7.5	6.8
Netherlands	. . .	4.1	4.5	5.3	6.3	6.1	6.0	6.1	6.9	7.8	8.0
New Zealand	5.1	5.0	4.6	4.5	4.8	5.0	5.3	5.3	4.8	4.9	5.0
Norway	4.7	5.0	5.2	4.8	5.1	4.1	4.7	4.7	4.7	5.1	5.5
Spain	4.4	4.1	4.4	4.1	4.4	4.7	4.1	4.0	3.1	3.6	. . .
Sweden	6.1	6.8	7.2	7.4	8.0	8.4	8.5	7.5	7.6	7.7	8.4
Share in Total Revenue and Grants											
Australia	20.3	19.4	17.4	16.4	16.3	16.9	17.0	17.0	15.8	15.0	14.6
Austria	21.9	20.3	19.7	19.9	19.7	19.5	18.1	18.9	19.1	19.7	19.7
Belgium	7.9	7.5	7.2	6.5	6.6	6.6	6.1	6.6	7.0	7.4	6.8
Denmark	14.3	15.3	14.9	17.8	20.1	18.9	19.5	19.5	20.1	19.4	19.2
Finland	16.1	16.0	15.8	17.0	16.7	16.5	17.4	15.8	14.3	13.4	14.3
Iceland	43.6	47.3	44.0	40.7	39.7	40.3	41.1	40.0	38.1	39.2	39.5
Ireland	30.5	28.4	28.3	26.7	26.5	25.6	25.7	28.4	29.6	30.5	30.0
Luxembourg	17.4	16.3	14.9	14.1	14.4	14.0	14.3	16.3	19.5	19.8	19.5
Netherlands	. . .	9.0	9.5	10.7	12.6	12.6	12.5	12.5	13.8	15.5	15.7
New Zealand	18.8	17.3	15.0	14.9	15.9	15.0	16.5	16.5	14.8	14.7	14.3
Norway	12.4	13.0	13.8	12.8	13.0	10.7	12.0	12.0	11.5	11.9	12.9
Spain	22.1	20.4	22.2	19.6	21.1	20.6	17.5	16.5	12.4	14.2	. . .
Sweden	17.9	20.7	21.9	22.0	20.8	21.2	21.6	19.6	20.1	19.8	21.4

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

the period. Only in Australia and New Zealand, which are not members of either organization, did this ratio remain roughly constant.

FISCAL BALANCE, FINANCING, AND DEBT ACCUMULATION

The period covered witnessed persistent and in most instances widening fiscal deficits (Table 2.11). Of the 13 countries, 8 incurred a deficit in every year of the period; another 3 experienced a deficit in every year after 1974; one country, Norway, realized its only surpluses in 1981 and 1982; only in Luxembourg was there a positive balance in central government finances over the period as a whole—surpluses in 1972–78 and in 1980 and 1982 but deficits in 1979 and 1981. The time pattern of the fiscal balance is demonstrated in Chart 4, which reveals a sharp deterioration in fiscal positions in the period 1974–75 as a result of an expansionary policy response to the recession in the wake of the first oil price shock. A partial recovery followed in 1976 and 1977, when growing internal and external imbalances, especially accelerating rates of inflation and widening current external deficits, induced governments to shift the stance of fiscal policy in a restrictive direction. Belgium and, to a lesser extent, Norway, where deficits continued to widen, are notable exceptions. After 1977, the results were mixed, but in 1979 and 1980, the years of the second oil crisis,. most countries experienced a renewed increase in deficits that in some cases continued over the rest of the period. However, in two countries, Australia and Norway, the 1980–82 period witnessed an improvement in fiscal positions, especially in Norway where oil revenue soared.

The countries that experienced the sharpest deterioration in their government finances relied increasingly on foreign financing of the deficits; a number of these countries had recourse, in growing measure, to domestic monetary financing to meet the borrowing requirement. These developments are discussed in some detail under individual country sections in Part II.

As a consequence of mounting fiscal deficits, government indebtedness increased in most of the smaller industrial countries over the period (Table 2.12). Expressed as a ratio to GDP, government debt in 1982 was the highest in Ireland, at 109 percent. Other countries recording high government debt were Belgium (74 percent), and Denmark and New Zealand (almost 60 percent each). There is evidence that these ratios have since expanded. By contrast, Finland's government debt was a moderate 12½ percent of GDP in 1982, and in Luxembourg, it was negligible. The rate of debt accumulation by the central government was

Table 2.11. Deficit/Surplus as a Percentage of GDP

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Australia	−0.3	−1.7	−0.5	−4.0	−5.0	−3.3	−3.7	−3.3	−1.8	−0.8	−0.3
Austria	−0.2	−1.6	−1.5	−4.0	−4.6	−3.7	−4.0	−3.7	−3.2	−2.9	−4.4
Belgium	−4.3	−3.5	−2.2	−4.7	−5.6	−5.9	−6.9	−7.6	−7.7	−12.3	−12.2
Denmark	2.6	3.5	0.7	−1.9	−0.4	−1.3	−0.3	−0.7	−2.7	−6.2	−8.3
Finland	1.2	2.9	0.8	−2.3	—	−1.5	−1.9	−2.6	−2.0	−1.0	−2.0
Iceland	−2.6	−3.1	−4.6	−6.2	−2.5	−4.4	−2.6	−2.2	−1.4	−0.8	−2.9
Ireland	−5.6	−6.8	−11.9	−12.4	−10.2	−9.5	−11.5	−12.1	−13.3	−15.0	−15.2
Luxembourg	1.4	2.5	3.9	1.0	0.3	0.6	2.7	−0.2	1.0	−1.6	0.5
Netherlands	...	—	—	−3.0	−2.6	−3.0	−3.1	−4.6	−4.6	−6.5	−7.6
New Zealand	−3.8	−2.5	−4.1	−10.2	−4.4	−5.1	−8.6	−5.3	−6.3	−7.2	−7.4
Norway	−1.5	−0.9	−1.4	−3.2	−5.9	−6.9	−6.8	−6.3	−1.8	2.1	0.8
Spain	−0.5	−0.3	−1.2	−1.8	−0.9	−2.2	−2.4	−3.5	−4.3	−7.1	...
Sweden	−1.3	−1.5	−3.3	−2.7	−0.4	−1.7	−5.2	−7.6	−8.7	−9.4	−9.9

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

Table 2.12. Central Government Outstanding Debt

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Ratio to GDP											
Australia	...	34.8	29.8	28.8	27.9	28.0	29.8	30.4	28.6	24.9	22.7
Austria	10.5	10.4	10.0	15.3	18.5	20.8	23.6	25.2	26.3	28.0	30.0
Belgium	45.0	42.5	39.0	40.0	40.3	43.2	46.2	49.7	54.8	65.2	73.9
Denmark	−1.6	−3.6	−1.7	4.5	8.4	13.2	18.2	24.7	33.7	45.9	59.2
Finland	6.6	4.5	3.0	3.5	3.9	5.2	8.5	9.1	9.3	10.1	12.3
Iceland	15.8	12.5	13.4	18.1	18.9	20.7	22.4	23.9	26.4	23.6	31.4
Ireland	52.3	59.7	65.0	73.4	79.2	77.9	82.1	89.5	91.4	99.3	108.7
Luxembourg	...	...	8.9	8.5	7.6	7.3	6.7	5.7	5.1	5.0	4.7
Netherlands	...	22.1	21.0	22.1	22.4	22.5	23.8	25.7	29.1	33.5	39.4
New Zealand	44.6	41.2	41.8	47.8	44.7	48.7	50.5	49.2	47.6	49.2	58.2
Norway	28.1	26.8	24.8	25.7	27.8	33.1	38.4	42.1	37.0	32.1	26.5
Spain	15.6	13.2	11.8	12.1	13.0	15.3	14.3	15.4	17.2	19.4	...
Sweden	16.6	16.7	18.3	18.9	17.0	18.3	21.3	25.7	32.3	38.8	45.4
Foreign Debt as a Percentage of Total Debt											
Australia	...	8.6	6.7	6.7	6.5	8.0	13.5	16.9	16.5	14.2	15.9
Austria	20.4	16.0	22.0	31.9	26.1	28.7	30.1	27.5	27.8	32.0	31.7
Belgium	1.7	1.1	0.8	0.8	0.6	0.5	1.4	3.9	8.1	15.8	20.9
Denmark	...	...	...	...	...	...	...	...	...	...	...
Finland	39.5	43.7	42.4	44.3	48.6	54.8	60.2	58.9	57.5	60.3	62.2
Iceland	66.6	65.4	70.2	61.9	61.3	64.6	69.1	62.7	58.1	54.7	65.7
Ireland	8.9	10.3	15.9	20.7	28.8	24.6	20.6	23.6	28.0	37.2	41.2
Luxembourg	...	...	8.2	7.8	6.6	5.6	4.8	4.3	3.5	2.2	1.2
Netherlands	...	0.1	0.1	—	—	—	—	—	—	—	—
New Zealand	16.0	12.4	20.4	26.2	29.0	32.6	33.0	34.4	36.4	38.5	41.4
Norway	5.9	4.3	3.7	14.6	20.5	26.3	34.1	32.0	28.4	25.0	22.5
Spain	5.4	4.8	5.1	4.7	7.3	14.3	8.9	7.1	4.6	4.9	...
Sweden	—	—	0.1	0.2	0.3	7.8	13.4	13.3	20.1	21.9	22.9

Sources: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984; national sources; and Fund staff estimates.

Chart 4. Smaller Industrial Countries: Fiscal Balances

(As a percentage of GDP)

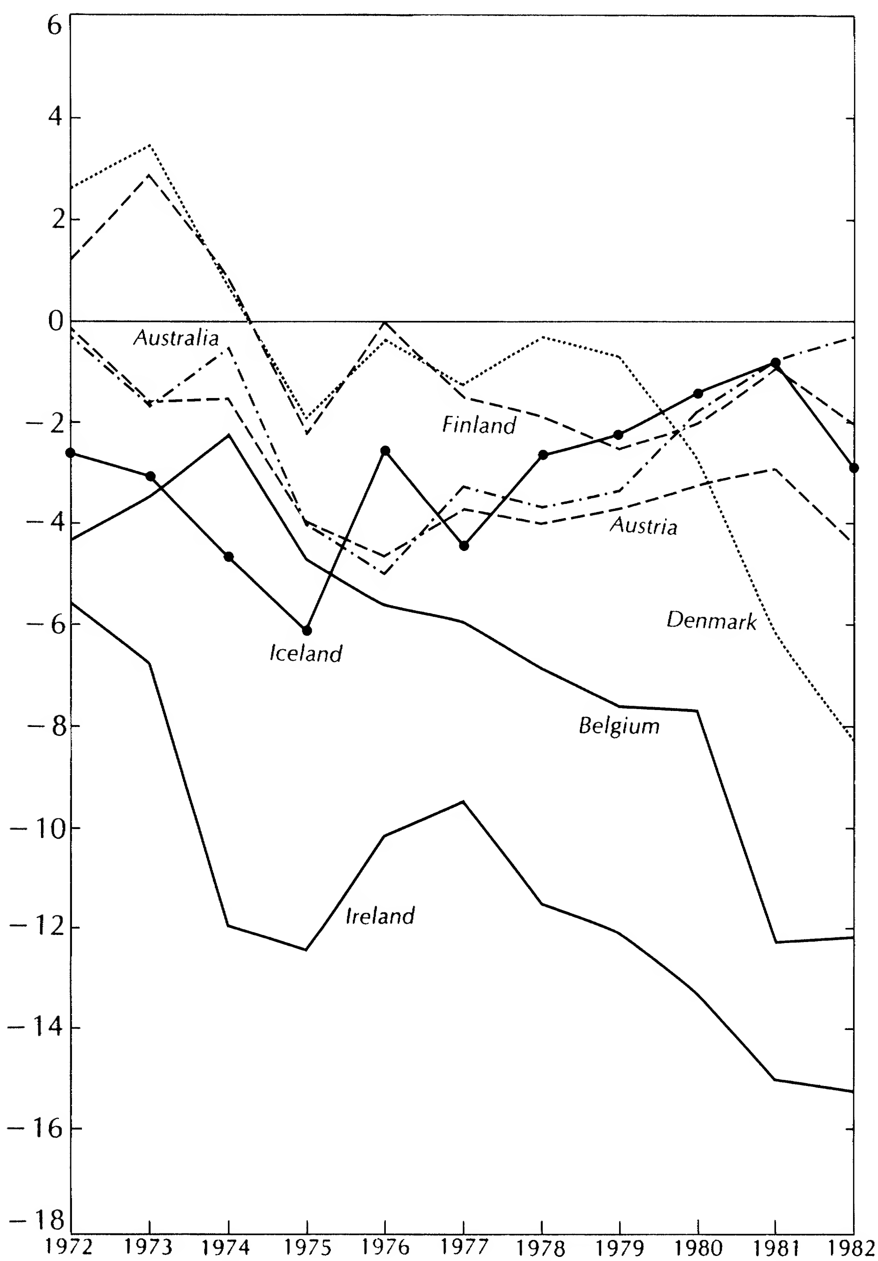
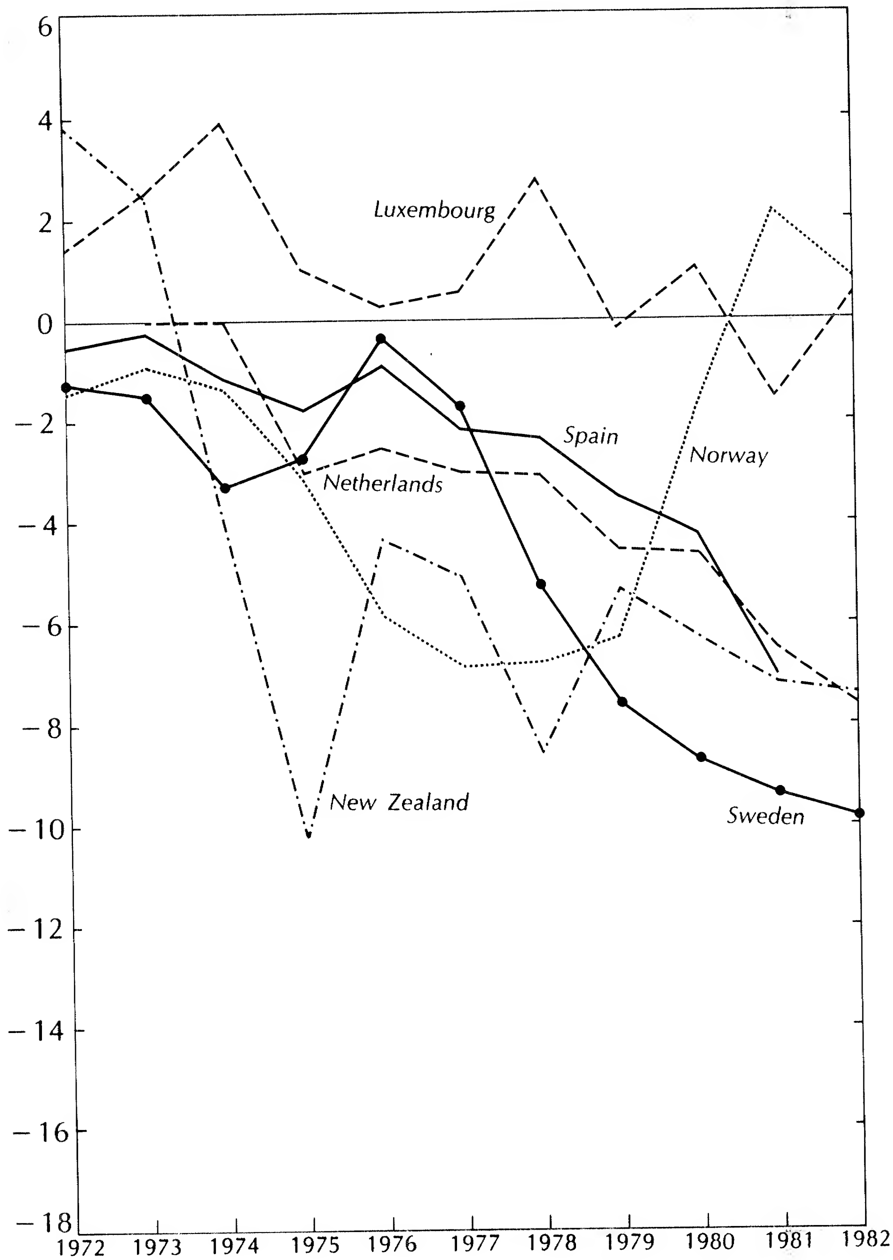


Chart 4 (*continued*). Smaller Industrial Countries: Fiscal Balances
(As a percentage of GDP)



most rapid in Denmark and Ireland, at 61 and 56 percentage points, respectively; the rate of expansion in Belgium and Sweden was also high, at approximately 30 percentage points each. In Australia, on the other hand, the ratio of government debt to GDP declined by 12 percentage points from 1973 to 1982. As already indicated, the external component of government debt grew over the period in most countries in the group. The fastest relative increase occurred in the same countries that had experienced the fastest expansion of total debt, with the addition of New Zealand and Finland whose external component grew at an unusually fast rate toward the end of the period. The external component was relatively largest in Finland and Iceland, at 62 percent and 66 percent, respectively, of total government debt, followed by New Zealand and Ireland, at 40 percent each; in contrast, the Netherlands and Luxembourg had no or negligible foreign debt at the central government level.

3

Fiscal Policy, 1972–82, An Overview

This chapter contains a broad account of the pursuit of fiscal policy over a decade that witnessed the largest economic imbalances experienced on a global basis in the postwar period. While the sheer magnitude of the external shocks emanating from the two oil crises and the ensuing world recession had a broadly similar impact on the smaller industrial countries, differences in individual circumstances caused deviations from the more general policy reactions. As this part of the study emphasizes the general aspects of fiscal policy, events peculiar to individual countries are given very limited coverage. Therefore, certain policy actions, although significant in a narrower context, may be neglected in this chapter. Some of these are contained in Part II, which deals with individual countries in some detail.

ECONOMIC SETTING AND FISCAL STANCE IN THE EARLY 1970s

The first two years of the period under review witnessed a continuation of the strong growth performance that most countries in the group had achieved during the 1960s. Expansion of economic activity in the latter half of 1972 and the first half of 1973, in particular, was accompanied by a marked acceleration of inflation rates that had been on the rise in most industrial countries since the mid-1960s. Concern over the inflation problem induced governments in a number of countries to tighten financial restraint policies. Partly as a result of the stricter stance of fiscal and monetary policies, signs of a slowdown of output expansion began surfacing even before the abrupt oil price increases late in 1973. Although levels of unemployment differed

substantially among the countries—Ireland suffered the highest rate of about 6 percent—the employment situation was not a problem, and most countries in the group actually experienced a fall in the unemployment rate in 1973. Similarly, in these years the current external balances were not a matter of great concern generally, although there were exceptions, such as Denmark, which experienced persistent balance of payments problems. In fact, 7 of the 13 countries had current account surpluses in both 1972 and 1973; that is, Australia, Belgium, Luxembourg, the Netherlands, New Zealand, Spain, and Sweden.

As indicated, inflation was a growing problem in the early years of the period, even before the first oil price explosion. All countries in the group experienced accelerated price increases in 1973, and in some countries inflation was regarded as the dominant economic policy problem. The rates of inflation differed markedly among the countries, however, with Iceland experiencing the highest rates (10 percent in 1972 and 20 percent in 1973), and Luxembourg the lowest (5 percent in 1972 and 6 percent in 1973). The policy response on the fiscal front in most countries was to tighten the stance, usually as part of a more general approach to overall demand management. About half the countries in the group succeeded in improving their fiscal positions from 1972 to 1973 (Table 2.11 and Chart 4), and in a few additional countries, the balance remained approximately constant. Only in four countries—Australia, Austria, Iceland, and Ireland—was there a marked increase in the fiscal deficit in 1973. In Australia, the increase was the result of a conscious policy of fiscal expansion; in Austria and Ireland, a higher priority was assigned to stimulating activity through increased public spending; and in Iceland, incomes policy-oriented tax and expenditure measures led to fiscal deterioration.

Although most countries in the group incurred fiscal deficits in 1972 and 1973 (Table 2.11), except Denmark, Finland, and Luxembourg, which realized surpluses in both years, the size of the deficits was generally small compared with subsequent developments, and deficit financing did not pose problems at this time. External financing was nonexistent in most countries, the only exceptions being Iceland and Ireland, which financed part of their public investment by foreign borrowing. Similarly, domestic monetary financing was in most instances not resorted to in any significant measure. On the contrary, a number of countries pursued active open market operations in support of monetary policy. Thus, in 1972 and 1973, in Australia, Belgium, the Netherlands, and Spain, more was borrowed from the nonbank private

sector than was needed to finance the deficit, in order to reduce liquidity in the economy, much of which stemmed from capital inflows. The proceeds were used to reduce external debt or to repay short-term domestic debt.

Fiscal policy achieved a fair amount of success in the early 1970s; moreover, improvements in fiscal positions contributed to the anti-inflationary efforts of general demand management. There are several explanations, both economic and political, for this success. An important one may be the relatively flexible fiscal systems that made possible the pursuit of flexible policies in these years. In the early 1970s, expenditure levels and tax burdens were substantially lower than they are now; automaticity in significant expenditure categories was much less pronounced, as were inflation-adjustment mechanisms on the revenue side. Public finances were generally more balanced than they later became, and interest payments did not constitute an overly heavy claim on budgetary resources in most instances. Moreover, tax reforms had been recently, or were being, undertaken at the beginning of the period in a number of countries; notably, the introduction of value-added taxes in countries connected with the EC. It was a widely held view at this time that these tax reforms would substantially improve the fiscal armory for both allocation and stabilization purposes.

Not all measures taken around this time were conducive to flexibility in fiscal policy, however. Foundations previously laid for generous social entitlement programs were being strengthened, and in a number of countries social security expenditure had been increasing rapidly since the 1960s. This development would prove a major element in the subsequent difficulties policymakers encountered in their attempts to control public expenditure growth.

POLICY RESPONSE TO FIRST OIL CRISIS

The abrupt increase in energy prices late in 1973 and in 1974, as well as the ensuing world recession, affected the smaller industrial countries profoundly: their economies were generally highly open and susceptible to external impulses, and most of them were not endowed with rich domestic energy sources. In a number of these countries, fiscal policy was the major instrument of economic stabilization, and the policy response was generally to shift the fiscal stance in a highly expansionary direction. This policy was broadly viewed as a proper reaction to the recession, which was believed to be short lived. Growth, it was argued,

would soon pick up globally and a more normal stance of policy could then be resumed.

The strength of the policy reaction to the recession naturally differed among individual countries, depending on their perception of the economic threat and domestic policies already in place. As indicated above, output expansion had started to slow down in some countries before the oil price explosion; for this reason, several of them had already introduced expansionary fiscal policies to counteract emerging slack in labor market conditions. Among these were energy-rich countries such as Australia, the Netherlands, and Norway, which might be expected to have been less severely affected by the oil crisis than other countries in the group. Similarly, domestic policies in Australia and, to a lesser extent, in Spain—the two countries in the group with the smallest foreign trade sectors—were actively directed at an expansion of social benefits and, in Australia, at a general expansion of public sector absorption of resources in line with the Government's policy at the time. A policy aimed at enlarging the role of the public sector in the economy was also being pursued in Luxembourg during 1974–75.

When the recession deepened and it became clear after the mid-1970s that the adverse impact of the oil crisis would extend to output and employment as well as to prices, the expansionary stance of fiscal policy was strengthened in almost all countries in the group. With the sharp deterioration in employment in 1975, the highest priority was shifted from controlling inflation, which had been considered the main problem in the preceding years, to maintaining employment. Although the type of expansionary measures differed in individual countries, they frequently included both expenditure increases and tax reductions and entailed a very sharp deterioration in the fiscal positions of all the countries except Sweden, which managed to contain its deficit until 1978.

A typical expenditure measure in these years was increased employment-oriented outlays, such as public investment, in some cases, through increased advances to states and local governments and subsidies to enterprises. Some countries, including Denmark, Luxembourg, the Netherlands, and Sweden, introduced special employment policies that were implemented through schemes either to increase public employment or to compensate private sector enterprises for increasing or maintaining the number of their employees. Also, a special boost was given to the objective of maintaining living standards through improvements in social benefits. Countries that pursued this policy with

special vigor were Australia, Belgium, the Netherlands, Spain, and most of the Nordic countries. Examples of more specific measures in 1974 and 1975 include activation of contingency budgets and release of frozen funds of local governments in Austria; relaxation of ceilings on local government investment and subsidization of interest costs on loans for residential construction in Denmark; and the setting up of special credit facilities for enterprises in the Netherlands.

In addition to expenditure measures, a number of countries implemented tax reductions to stimulate the economy. These often took the form of reductions in personal income tax rates or tax incentives for private sector investment, such as rate reductions and, more often, special depreciation allowances. In Austria, the Netherlands, and Denmark, the high tax burden motivated a reduction in income taxes. In Denmark especially, considerable political opposition in 1975 over the high marginal rates of the income tax led to a substantial reduction in personal income tax. Also in Denmark, revenue measures to stimulate demand included a large reduction in 1975 in the value-added tax; similarly in Ireland, items were exempted from the value-added tax. Several countries introduced special tax incentives, originally on a temporary basis, to encourage transfer of resources to the export sector. The fiscal measures thus usually aimed at the stimulation of both investment and private consumption. Norway is the one notable exception. As investment levels were already high in Norway, the authorities decided instead to stimulate private consumption, with improvements in social security benefits and income tax reductions playing a significant role.

SHIFT IN FISCAL STANCE AFTER MID-1970s AND CHANGES IN POLICY APPROACH

Shortly after the mid-1970s it was becoming widely recognized that the strength and duration of the recession had been underestimated. While economic activity had picked up in most countries in the group in 1976 and the unemployment situation had stabilized in a few countries, these did not prove to be lasting improvements. Although two years of highly expansionary fiscal policies had contributed to the temporary improvement, it was nonetheless clear that these policies had at the same time fueled accelerating rates of inflation and widening current external deficits. These developments were of grave concern to govern-

ments in the smaller industrial countries; they generally responded by endeavoring to redirect the stance of fiscal policy in a restrictive direction.

The economic imbalances, which in a number of countries had reached unprecedented proportions in the postwar period and were assuming an increasingly structural character, brought about a shift in policy approaches in many countries. There was growing recognition that the imbalances could not be eliminated in the short term, and a few countries, including Finland, Ireland, and Spain, adopted medium-term overall economic policies to address the problem. To reinforce their political resolution to restore fiscal balance, a growing number of countries publicly announced specific medium-term fiscal targets for the containment or reduction of fiscal deficits, tax burdens, or public expenditure/GDP ratios, or all of these. Another, and perhaps more fundamental, change in approach emanated from a growing doubt as to the appropriateness of traditional demand management policies in dealing with economic imbalances of this magnitude. Such policies were seen as liable to cause still higher rates of unemployment. Views of this kind were expressed at different times, for example, in Australia, Ireland, the Netherlands, and New Zealand. Preference was expressed for measures that would be directed at the cost side by attacking the wage-price spiral or measures that directed resources into the export sector. Of course, certain countries in the group already had long experience with measures of this kind, notably incomes policy measures, but selective measures tended to assume an enhanced role in the following years.

While there was growing awareness of the need to improve fiscal positions, most governments nonetheless remained committed to the objective of stimulating employment and economic activity and to preserving living standards. This set of objectives posed an acute dilemma for fiscal policy and frequently led to inconsistencies in the pursuit of policy, as discussed in the following section. A number of countries addressed the problem by adopting strategies that sought to maintain a restrictive overall stance of fiscal policy while at the same time introducing selective measures of stimulus that would not impart undue pressure on prices and the current external position. This approach was perhaps most clearly spelled out in the so-called dual strategy followed in Austria.

The results of these changes in approach were mixed, however, as fiscal deficits did not generally decline in subsequent years, although in

many instances they tended to stabilize. But with a few exceptions, levels of expenditure continued to rise in relation to GDP, as did tax burdens. The commitment of governments to cushioning the adverse impact of the recession on the economy and living standards meant the maintenance and, in several cases, intensification of measures from the preceding period of fiscal expansion and even the introduction of new ones.

The selective measures taken at this time and in subsequent years included various public investment programs, special employment promoting schemes, personal income tax reductions, and selective tax incentives for investment, including tax credit for special types of investment. Social benefits remained in many countries the underlying force of expenditure growth because of demographic factors, rate increases, extension of coverage, and the automatic effects of the depressed state of economic activity on unemployment compensations. Indexation mechanisms relating to personal income taxation as well as significant expenditure categories proliferated over the period. In some countries, fiscal measures to support incomes policies were pursued vigorously, commonly entailing both increased spending and revenue loss. As the decade progressed and structural problems became more pronounced, selective measures increasingly took the form of industrial support, including transfer of resources to the export sector, interest cost subsidies, assumption of loan obligations, and the granting of loan guarantees.

To counteract an undue expansionary impact of these selective measures, a common response was to increase indirect taxes, such as the value-added tax and, in some cases, taxes on energy use. Indirect tax increases were especially pronounced in Austria, Denmark, Iceland, Ireland, and the Netherlands. Also, in certain countries, including Austria, Belgium, the Netherlands, and especially Spain and Sweden, social security contributions rose rapidly, sometimes with adverse repercussions on business activity and employment. Australia, the Netherlands, and Norway benefited from a large increase in revenue from oil and natural gas in the later years of the period. However, the protracted recessionary conditions generally retarded revenue growth. Most countries tried to contain overall expenditure growth from 1976 onward, but with little success.

Although some countries were initially able to improve their fiscal positions, it soon became clear that notwithstanding public policy announcements of fiscal restraint, several obstacles blocked restoration

of fiscal balance; the record shows that for the rest of the period, most countries had severe fiscal difficulties.

POLICY RESPONSE TO SECOND OIL CRISIS

The second oil price explosion in 1979 contributed to a renewed slowdown in economic activity, an upsurge in prices, and widening current external deficits. These events proved to be a major obstacle to fiscal improvement. Mindful of the disappointing experience with expansionary fiscal policies in the wake of the first oil crisis, governments generally reacted cautiously, and initially the battle against inflation was assigned priority. In contrast to the policy stance during 1974–75, fiscal policy remained tight for a time, as far as discretionary action was concerned. Apart from the need for fiscal adjustment, which had grown continuously in preceding years, the tight fiscal stance was required to support the efforts to prevent the impact of the oil price increase from causing a domestic wage-price spiral.

As already mentioned, the practice of stating policy objectives in quantitative terms had become more common, and by this time more than half the countries in the group had announced specific fiscal targets for restoring balance over a specified period. The second oil crisis upset basic assumptions underlying such plans, with the result that countries found it necessary to phase reduction of the deficit over a longer period of time. Improvements in external conditions also tended to be viewed as a prerequisite for fiscal adjustment, while additional factors further contributed to the slippages in the tight fiscal stance that soon emerged in a number of countries. Thus, as a result of deteriorating employment, some governments intensified employment-supporting measures, including wage-cost subsidies. In other instances, social security expenditure and support to industries facing difficult structural adjustment problems were increased. In addition to slippages in the policy stance, fiscal adjustment after the second oil crisis was further complicated by the responses of the automatic stabilizers to the recessionary conditions and by a markedly reduced scope for fiscal action on account of growing rigidities in fiscal systems. These issues are considered in the following chapter.

FISCAL POLICY AND PROSPECTS IN THE EARLY 1980s

The plans for fiscal adjustment that have been announced in many of the smaller industrial countries and expressed as specific medium-

term fiscal targets are in some cases supplemented with programs in specific areas. Some of these programs have already been formulated with a considerable degree of precision and are even in varying stages of implementation; others are still under consideration. In still other instances, there is general awareness of an urgent need to undertake a fundamental restructuring of the public finances, but political controversies have hampered progress. This section concludes with a brief look at some of these programs.

In Austria, Belgium, and Spain reforms or reviews of the social security system are being undertaken. In Austria a contemplated review would pay particular attention to the pension system. In Belgium, where the financial position of the social security system has deteriorated rapidly, measures have been taken to limit the increase in benefits, and a comprehensive review is being worked out that would improve efficiency with respect to income redistribution and work effort. Also under consideration is a new means of financing the system that would cease to distort the cost of labor relative to other domestic factor costs. In Spain, although the economic program aimed at improving the social security system was initiated in 1977, progress has been slow. Renewed efforts are being made, however, to reduce anomalies in the present system, with special emphasis on its negative impact on labor costs. In Denmark and Iceland measures have been taken to reduce automaticity in expenditure decisions by suspending indexation mechanisms. How permanent this arrangement will be, however, remains to be seen. And, on the expenditure side, although not intended as a fiscal adjustment, Luxembourg's substantial new and temporary budgetary outlays to restructure the steel industry were largely financed by increased taxation, probably of a more permanent nature; and in Sweden there has been a growing tendency in recent years to make industrial support conditional upon restructuring.

Programs relating to the revenue side are more equity and efficiency oriented, although revenue-raising objectives are also involved. In New Zealand a tax reform was initiated in 1982, with the aim of reducing progressivity in the income tax to reduce its adverse impact on work effort and initiative, tax compliance, and resource allocation. Extension of the sales tax or the introduction of a value-added tax is under consideration. In Norway progression of personal income taxes at the lower income levels and heavier taxation of higher incomes is being considered, as well as an enlarged share of indirect taxes. And in Sweden, where marginal income tax rates are among the highest in

industrial countries, the adverse impact on work incentives, in particular, induced the authorities to prepare a reform of the personal income tax system for implementation in 1985; under the reform, the marginal rates would be reduced substantially and the revenue loss met, inter alia, by a reduction in the indexation of tax brackets and a ceiling on interest deductibility. Finally, several countries have in recent years implemented a series of reductions of social security contributions to lessen the cost of labor.

4

Obstacles to Fiscal Improvement

Apart from the external shocks discussed in the preceding section, obstacles to fiscal improvement encountered by most of the smaller industrial countries since the mid-1970s are diverse and include elements of both an economic and political nature. This chapter deals with those issues that relate to the working of automatic stabilizers in recessionary conditions, growing rigidities in fiscal systems that restricted the scope for fiscal policy action, and the ineffectiveness of multiyear budgeting, combined with a potential upward pressure on public spending generated by certain forecasting practices. Moreover, although political considerations usually pose complicated and controversial problems, an applied study of fiscal policy would suffer seriously from a total omission of this important issue. Therefore, on the basis of experience over this period, certain aspects of fiscal politics are considered.

RECESSION AND THE WORKING OF AUTOMATIC FISCAL STABILIZERS

The protracted recessionary conditions strained government finances through both sides of the budget. Sluggish economic growth slowed down the growth of revenue, and on the expenditure side social security schemes in particular triggered increased spending. Experience indicates that automatic stabilizers steadily weakened fiscal positions over the period and constituted an especially strong obstacle to fiscal improvement in the wake of the second oil crisis when governments endeavored to maintain a tight fiscal stance.

On the revenue side the practice of reducing personal income taxes was already common in a few countries at the beginning of the period. To counteract fiscal drag caused by accelerating inflation, adjustments of

tax brackets and standard deductions to price indexes were widely used. While these practices had usually been initiated on an ad hoc basis, a growing tendency arose to adopt indexation mechanisms that automatically adjusted rates and deductions for inflation. Also, a growing number of countries reduced real rates in order to stimulate private sector demand and to lower the tax burden, especially on low- and middle-income groups. In countries where government interference in income formation was customary, income tax reductions were frequently determined in the context of incomes policy. Although a number of countries granted tax relief of various kinds to the enterprise sector to stimulate investment and activity, the personal income tax reductions were generally most instrumental in affecting automatic stabilizers on the revenue side, because they eroded the impact of the progressive rate structure. It should be noted, however, that this was not a uniform experience in all countries in the group. In Belgium, for example, the tax system remained highly elastic with respect to GDP, because for most of the period the progressive income taxes were only partially adjusted for the impact of inflation. Also, in New Zealand, the highly progressive personal income tax rates continued to produce sharply increased revenue yields in the inflationary conditions, despite a series of tax reductions.

An outstanding feature of fiscal developments over the period was an explosive growth of social security expenditure. In the present context, it is significant that underlying this development are various schemes that provide for automatic compensations when specified criteria are met, including certain age limits, employment status, degree of disability, and, in some cases, family size and income level. In most countries in the group these criteria underwent a series of changes over the period that normally implied improvement in benefits—both increases in real benefits and extension of their coverage; it became a widespread practice to incorporate indexation mechanisms in the various schemes. A number of countries, including Belgium, Denmark, Ireland, Luxembourg, and Sweden, introduced early retirement schemes, usually in connection with employment policies, with the aim of withdrawing wage earners from the labor force. The impact of these measures was felt with growing force in budgets as was the impact of increasingly generous benefits of other types, including relaxed qualification criteria for unemployment and disability compensations.

The budgetary burden of the various social security schemes was aggravated by demographic factors, which over the period broadened

the basis on which automatic stabilizers work. The most important of such factors is the aging structure of the population whose impact on pensions and health care costs was especially strong in Belgium, Finland, the Netherlands, and Sweden. The rising ratio of pension receivers to members of the work force who contribute entailed growing budgetary transfers to pension funds. Increased female participation rates enlarged the size of the labor force and implied higher unemployment compensation costs, most notably in Denmark and New Zealand. A similar impact emanated from migratory flows of the labor force from abroad and from agriculture in Ireland and Spain.

NARROWED SCOPE FOR FISCAL POLICY ACTION

A fairly widespread development in these countries over the past decade is a growing tendency to determine expenditure by specific legislation rather than in the annual budget, thus providing for present and future expenditure commitments. The budgetary burden of such commitments is frequently aggravated by the practice of linking the relevant expenditure categories to a price index. As noted in the preceding section, various social security schemes are typical of such commitments, but other expenditure categories are also based on specific legislation or contracts with similar long-term implications. While legislation and contracts can be amended, such action is subject to cumbersome parliamentary processes or lengthy renegotiations that impart an element of inflexibility to fiscal policy. Rigidities in fiscal systems have increasingly restricted the scope for implementing needed fiscal adjustment in several countries in the group.

Persistent fiscal deficits in most of the smaller industrial countries have led to a mounting debt-servicing burden. For example, by the end of the period five countries in the group had to devote 8½ percent to 13 percent of total expenditure to interest payments on the government debt. The debt-servicing burden of several countries in the group could well increase sharply over the next several years, thus absorbing an increasing proportion of budgetary resources. For some countries in the group, this likely development is the major cause of the growing inflexibility being built into future fiscal policy.

A precise measure of rigidities in fiscal systems is not available for most countries in the group, but a look at the systems in three of the countries may throw some light on the issue, even if the data are not comparable across countries. In Denmark, major expenditure categories, notably transfers to persons and to local governments, are based

on law; at the central level, such categories accounted for approximately 50 percent of total government expenditure at the beginning of the period.[1] In Iceland, it has been estimated that about 70 percent of total expenditure is "'uncontrollable,' in that this portion of central government expenditure cannot be affected except by amending laws or contracts."[2] And in Sweden an estimated 80 percent of central government spending is determined automatically, owing to indexation and previous spending commitments, and about 50 percent of expenditure is automatically indexed.[3] As indicated, the percentages quoted above refer to different years within the period and have most likely risen since the calculations were made.

As already noted, a widely used device to cushion the adverse impact of external impulses and the recessionary conditions on economic activity and living standards was to reduce income taxes. As fiscal positions deteriorated, an increasing number of countries sought to compensate for the revenue loss by raising indirect taxes, such as value-added or sales taxes, excise duties, and energy taxes. However, this policy soon encountered difficulties, as increases in indirect taxes were reflected in the price level and further price increases tended to be generated through indexation mechanisms or indirectly through higher wage claims. In several countries, governments thus found themselves severely restricted by the inflationary implications of their efforts to improve the fiscal positions by raising indirect taxes.

ROLE OF MEDIUM-TERM PLANNING AND BUDGETARY FORECASTING

Most countries in the group have a tradition of multiyear planning or budgeting. The forms and procedures differ considerably from one country to another with respect to coverage, relation between the plans and annual budgeting, and degree of sophistication in forecasting techniques. Only two countries, Austria and Iceland, have relied entirely on annual budgeting. The arrangements and procedures in individual countries are further considered in Part II.

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[1] Denmark, Ministry of Economic Affairs and the Budget, *The Danish Budgetary System* (Copenhagen, 1972), p. 5.

[2] Gísli Blöndal, "Balancing the Budget: Budgeting Practices and Fiscal Policy Issues in Iceland," *Public Budgeting and Finance*, Vol. 3 (Summer 1983), p. 58.

[3] Björn Eriksson, "Sweden's Budget System in a Changing World," *Public Budgeting and Finance*, Vol. 3 (Autumn 1983), p. 70.

Multiyear budgeting serves to enhance rational choice by viewing the implications of past and present decisions in a longer-term perspective. In principle, the emphasis is on improving resource allocation and on ensuring a sustainable long-term balance between expenditure and the availability of financial resources. With rising future expenditure commitments and a growing need for efficient financial management, the case for medium-term budgeting might have been expected to strengthen. However, in view of publicly announced commitments to curb expenditure growth and to contain or reduce fiscal deficits, it is surprising to find that multiyear budgeting was so ineffective in pursuing these official policy objectives.

It is inherently difficult to appraise the actual policy relevance of long-term budgeting and other forecasting techniques, because political decision making in budgetary matters rarely emerges in a tangible form. However, it is important to note that multiyear budgets in these countries do not constitute future commitments on the part of governments; rather, they are viewed as an aid to fiscal decision making. The noncommittal nature of multiyear budgeting is generally intended to preserve flexibility in fiscal policy and to prevent undue future growth in expenditure. During the period under review, it would appear, however, that lack of commitment presented in a systematic and legal form contributed to the failure of this approach to act as a brake on political pressures for increased spending and weakened governments' resolve to observe self-imposed spending limits.

The limited effectiveness of medium-term budgeting may also be explained by the disturbing impact of external developments on the small and open economies, which tended to grossly upset basic assumptions of medium-term forecasts and resulted in a loss of confidence in such exercises. Toward the end of the period, countries such as Norway and the Netherlands, both of which have a long history of sophisticated budgeting techniques, moved away from the longer-term approach. Norway ceased to prepare the traditional medium-term programs, while the Netherlands abandoned the structural approach to fiscal policy as growing imbalances in the economy obscured the distinction between cyclical and structural factors and external uncertainties complicated the projection of medium-term trends in the economy. In Denmark long-term planning and public discussion did not prevent an explosive growth of public expenditure and a sharp deterioration in the fiscal position.

Tendencies to make unrealistic assumptions about the growth potential of the economy are known to have led to the setting of overambitious fiscal policy goals, with adverse implications for the budgetary position. Such tendencies were pronounced in Dutch budgetary forecasting, notably in the latter half of the period. Ireland had a similar experience in the 1978 national economic planning exercise that was subsequently abandoned because of the disturbing effects of the second oil crisis. In the Netherlands, the impact on expenditure growth was strengthened as, contrary to intentions, multiyear expenditure estimates were in fact widely regarded as minimum commitments on the part of the Government. Overoptimistic assumptions in medium-term budgeting thus introduced upward pressure on government spending; and although the experiences of only two countries in the group are quoted here, the phenomenon is probably more widespread.

It may be noted that, somewhat ironically, the two countries in the group—Austria and Iceland—that did not resort to multiyear budgeting over the period in question appear to have fared relatively well in overall fiscal performance. Thus, Austria managed to contain expenditure growth and increases in the fiscal deficit below the average for all the countries in the group; and Iceland experienced one of the smallest relative increases in expenditure over the period.

FISCAL POLITICS

A major problem in public finance derives from the interdependence of the general aims of fiscal policy. Improvement of resource allocation to strengthen the basis for long-term growth of the economy, change in the distribution of income, and promotion of economic stability are objectives ordinarily sought implicitly or explicitly in each year's budget, but measures designed to obtain one objective are liable to affect one or more of the others. As the effects tend to be mutually adverse, an efficient fiscal policy would have to take this interdependence into account. This in turn implies a requirement on the part of governments to establish a clear order of priorities among the different objectives and to follow a reasonably steady and resolute course of policy implementation.

The failure of policymakers to set priorities within a context of interdependent but conflicting objectives contributed to inconsistent policy actions over the period, as ample evidence has proven. Conflict of objectives can arise not only between the general aims of fiscal policy but

also within the same broad objective. In this period of pronounced economic imbalances, stabilization measures in different areas provide the clearest evidence of such inconsistencies. As already noted, major stabilization measures were designed to stimulate employment and economic activity, combat inflation, and improve the current external position. While the latter two objectives would generally be sought through a tightening of the fiscal stance, the first would be served by expansionary measures. So far, this analysis has shown that on several occasions during the period all these measures tended to be introduced at the same time or in rapid succession, without reference to a clear ordering of priorities. The impact of restrictive measures to counteract rising prices and widening deficits on the external current account was frequently reduced or more than outweighed by measures to promote employment, economic growth, and social welfare. Attempts to solve this dilemma by selective stimulative measures that would not impart undue pressure on prices and the external current account position appear not to have been very successful.

The frequent changes in the stance of fiscal policy in several countries over the period are not necessarily a sign of inconsistency, as they may in part reflect a response to changes in underlying economic conditions. However, the evidence strongly suggests that such changes also resulted from political considerations that took limited notice of economic circumstances or attempted to achieve short-term gains that often were at the expense of the longer-term performance of the economy.

The problem of inconsistent policies may in part be explained by the political structure of the countries. The smaller industrial countries all have a system of political democracy, often characterized by a number of relatively small political parties and, of necessity, coalition governments. In some of the countries, minority governments are not uncommon. As a result, the formation of strong governments with consistent and clearly defined objectives is rare and changes of government tend to be frequent. The political environment thus is not generally conducive to the formulation of consistent long-term policies, and the frequent changes of government, in particular, are liable to weaken effective resistance to pressures for increased public spending. Priorities among governments may differ, and new governments will tend to initiate new expenditures without making offsetting reductions in existing areas; or, different and changing political ideologies can frustrate any planned long-term expenditure goals. A case in point is

Australia where the government in office during 1972–75 pursued the policy of increasing the public sector's absorption of resources, so as to change the social fabric over a short period of time. The government that took office at the end of 1975, by contrast, regarded the sharply enlarged role and relative size of the public sector as a major cause of depressed private sector activity and, for most of the remaining years of the period, managed to reduce the ratio of government expenditure to GDP.

The significance of the political element in the formulation of fiscal policy in these countries is thus fairly obvious. It is also clear that imperfections in the political system, from an economic viewpoint, have contributed to difficulties in achieving desired fiscal adjustments. The precise manner in which political decision making influences the formulation of fiscal and economic policy is beyond the scope of this study. However, the above observations would appear to lend support to the assertion advanced in theories of political behavior that a major objective of government is self-preservation. In the present context, it would appear plausible that "governments may be more interested in stabilizing votes in the short run than the economy in a somewhat longer perspective."[4]

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[4]Assar Lindbeck, "Stabilization Policy in Open Economies with Endogenous Politicians," *The American Economic Review*, Vol. 66 (May 1976), p. 17.

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Implications of Past Fiscal Developments and Policies

In this chapter, a desirable method of analysis would have been to link movements in the fiscal data presented in Chapter 2 to indicators of economic performance; however, such an approach was not possible for a number of reasons. First, the period for which comparable data were available was too short to permit meaningful conclusions to be drawn. Second, the available statistics were not detailed enough to enable identification of expenditures that match the separate schemes dealt with below, such as unemployment compensations, pensions, employment support, and incomes policy-oriented schemes. Third, the issue of causation referred to below would in any case have rendered such an analysis inconclusive. The following analysis is, therefore, based largely on separate studies as quoted, while reference is made to the statistical data in particular contexts.

ENLARGED PUBLIC SECTOR

The growing size of the public sector, combined with poor economic performance over the past several years, has lent support to the opinion that an inverse relationship exists between the two. The sharp increase in public expenditure relative to GDP and a concomitant increase in tax burdens and fiscal deficits are seen as a major cause of the difficulties many countries are facing in terms of sluggish economic growth, high rates of unemployment, and rapid price increases. Implicit in this hypothesis is the view that an effective way to cure the economic malaise is to reduce the relative size of the public sector and government interference in the market mechanism. While public sector size is commonly interpreted as total public expenditure in relation to GDP, the

argument against large government somewhat confusingly concentrates more on the financing of expenditure by stressing the adverse impact of heavy tax burdens and deficit financing on economic performance. A similar impact is seen as emanating from separate expenditure schemes rather than from expenditure at the aggregate level. Although these items are obviously closely interdependent, it is useful to consider them separately, beginning with aggregate expenditure.

The contention that large and growing government adversely affects economic performance appears to rest on assumptions that reflect a mixture of economic criteria and ideological persuasion. Among the former is the doctrine that as the public sector grows beyond some unspecified limit, resources are diverted from more productive use in the private sector, and economic growth suffers. Moreover, the theory that increased expenditure in conditions of less than full capacity utilization has a beneficial impact on growth, in line with traditional Keynesian multiplier analysis, has come under growing critical scrutiny, because it disregards the financial stringencies of taxation and deficit financing. Also, public sector growth is allegedly associated with growing government interference in the market mechanism, which distorts optimum resource allocation, with adverse repercussions on the long-term growth performance of the economy. Regarding price performance, the size and rate of growth of the public sector may, depending on the degree of capacity utilization, affect the rate of inflation through the traditional Keynesian aggregate demand influences. A causal relationship between public sector size and unemployment may be expected to be largely indirect, however, through the impact of slower economic growth. Unemployment is, indeed, more likely to expand the public sector in terms of increased outlays both to compensate the unemployed and to stimulate employment through discretionary action.

The argument against large government has been challenged on the ground that it rests on assumptions that indirectly imply certain ideological and political value judgments rather than economic logic. It is argued that critics of large government assume the efficacy of the invisible hand and the superiority of freely functioning markets. According to the proponents of large government, the case for the alleged harmful consequences of large government, such as lower productivity than in the private sector, inherent inefficiency, and diminished freedom, rests on such doctrines, rather than on verifiable evidence. The central role attached to the market mechanism is further challenged by sympathizers of large government on the ground that

such a view largely disregards egalitarian values, which, of course, removes the issue from the realm of economic analysis.[1]

Whatever the attitude toward the size of the public sector, it is generally recognized that public expenditure generates economic and social benefits. The question is whether there is a point beyond which expenditure growth begins to exert a harmful impact on economic performance. Considering the prominence of this issue in public debate in recent years, it is surprising that the subject has been given only limited coverage in the literature. However, a recent Organization for Economic Cooperation and Development (OECD) study addressed this issue and reviewed available empirical evidence on the economic consequences of the size and growth of public sector activity. It was found that previous research had not succeeded in establishing strong relationships between economic performance indicators and public sector size and growth at the aggregate level. The study reaches the unsurprising conclusion that "it is extremely difficult, if not inherently impossible, to arrive at an objective assessment of the economic consequences of the broad range of public sector activities. Not only do the outcomes of many activities defy quantification, but there are additional problems associated with any attempt to aggregate across programmes."[2]

Analyzing the economic consequences of the size and growth of the public sector immediately focuses attention on the composition of expenditure, since it is generally accepted that separate expenditure categories affect the economy differently. But the usefulness of analyzing expenditure at the aggregate level then becomes questionable, not least if the emphasis is on comparison over time or across countries. If the composition of expenditure has changed sharply over time or if it is substantially different in individual countries, the economic impact may be markedly different, even though the relative size of the public sector remained unchanged over time. The issue of causation raises an additional problem, as factors outside the realm of public finance can influence economic performance, and their impact is not separable from that of fiscal factors. These are serious limitations from an analytical point of view, and underscore the need for caution when the implica-

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[1] For a thorough examination of these issues, see David Heald, *Public Expenditure: Its Defence and Reform*, Oxford: Martin Robertson, 1983.

[2] Peter Saunders and Friedrich Klau, "The Role of the Public Sector: Causes and Consequences of the Growth of Government," *OECD Economic Studies* (Paris), No. 4 (Spring 1985), p. 21.

tions of expenditure are being interpreted at the aggregate level, or when the relationship between the size and growth of the public sector and economic performance is being examined. The analytical ground is firmer with respect to separate taxes and expenditure schemes, and these aspects, together with fiscal deficits, are considered in the remainder of this chapter.

INCREASED TAX BURDENS

Generally, the ratio of total revenue and grants to GDP rose during the period, although the rate of expansion differed markedly among individual countries in the group, as noted in Chapter 2. While few would support the argument that tax burdens had not risen enough, expenditure growth was in most cases substantially faster. This disparity in growth rates therefore entailed large and, in most cases, widening fiscal deficits, with adverse economic implications as considered in the following section.

Most countries in the group have a progressive tax structure and an otherwise responsive tax system, although these features differ from one country to another. Despite the prolonged recession, high rates of inflation were widely experienced, so that even in the absence of discretionary revenue-raising measures, rising nominal incomes and turnover might have been expected to produce revenue yields that were more in line with expenditure growth. Also, three energy-rich countries in the group—Australia, the Netherlands, and Norway—benefited from an upsurge in revenue from oil and natural gas. However, policy objectives to cushion the adverse impact of external impulses on the economy and to preserve living standards resulted in a series of tax reductions over the period, which contributed significantly to the slowdown of revenue growth. The ways in which tax cuts were intended to counteract the recessionary impulses were manifold and included reduction of disincentive effects of high marginal income tax rates; containment of tax burdens; redistribution of income in favor of lower income groups; stimulation of private sector demand, investment, and employment; and moderation of wage settlements.

The general economic impact of high tax burdens is not easily determined and, as is the case with expenditure at the aggregate level, much depends on the composition of the various types of taxes and other revenue sources. Attempts have been made to establish specific limits beyond which the tax burden begins to exert an adverse impact on

the economy. The best known is probably Clark's celebrated thesis, first published in 1945, that the safe limit of taxation is 25 percent of net national income, and as soon as total taxation exceeds that limit inflation pressures are generated.[3] Although this proposition has been refuted by the empirical evidence, it is easily conceded that there are some limits beyond which taxation at the aggregate level becomes excessive. However, due to the complexity of this issue, including its interdependence with the relative size and composition of expenditure, the implications of high taxation are more easily dealt with in terms of individual taxes.

The tax reductions mentioned above related largely, though not exclusively, to direct taxation, notably personal and corporate income taxes and social security contributions. However, in certain countries the progressiveness of personal income tax rates and the self-financing nature of the social security system caused a substantial increase in these two types of tax, which in many countries are the principal revenue sources at the central level. The increased burden of these particular taxes had detrimental economic implications; examples from selected countries are provided below.

In Belgium, the progressive income tax rates were for most of the period only partially adjusted for inflation. As a result, the tax burden rose markedly over the period, raising concerns about potential encouragement to the underground economy and tax evasion. In New Zealand, the significance of the personal income tax is a striking feature of the tax system; over the period it accounted for the entire relative increase in revenue—7 percentage points of GDP. It is a commonly held view that the steep progressivity of the personal income tax rates has adversely affected work effort and initiative, encouraged tax avoidance and evasion, and contributed to wage-push pressures and distortions in resource allocation. In Norway, income tax progression is quite steep, with marginal rates ranging between 30 percent and 70 percent; and about one third of taxpayers face a marginal tax of 50 percent or more. The adverse impact on work effort, savings, and income distribution is considered to be especially marked. In Sweden, despite a series of reductions, the personal income tax rates are still among the highest in industrial countries, with the highest marginal rate reaching 85 percent.

[3] Colin Clark, "Public Finance and Changes in the Value of Money," *Economic Journal*, Vol. 55 (December 1945), pp. 371–89. For a restatement of this proposition see his article, "The Scope for, and Limits of, Taxation" in *The State of Taxation*, by A.R. Prest, and others (London: Institute of Economic Affairs, 1977), pp. 19–34.

Not least among the various problems this high rate has occasioned is the detrimental impact on the work effort.[4]

Turning to social security contributions, the importance of this tax is especially marked in the Netherlands where it is equivalent to 19 percent of GDP and is the most important single revenue source of the central government. Employers bear about one half of this tax, which has grown over the period in relation to both total revenue and GDP and has seriously aggravated the cost position of a depressed enterprise sector. In Spain, social security contributions are by far the largest revenue source, accounting for almost one half of total central government revenue and grants. About 80 percent of this tax, which has grown sharply along with a concomitant increase in wage costs, is borne by employers. By 1980 these contributions were about 25 percent of the total wage bill, having risen from 16 percent in 1973. As a result, factor costs are distorted against labor, which is especially detrimental in a country like Spain that faces a serious unemployment problem. In Sweden, revenue developments over the period were characterized by a rapid increase in social security contributions. These have been borne increasingly by employers and amounted in recent years to some 35 percent of the total payroll, compared with 14 percent in 1970. This burden has intensified the strains on private sector activity.

Finally, although the revenue loss resulting from cuts in direct taxes was partially offset in some countries by increases in indirect taxes, most countries encountered difficulty in taking this course of action. For one thing, the shift toward indirect taxation was complicated by the significance of specific rather than ad valorem taxes and duties. An even greater obstacle was the concern over the impact on costs and prices. Despite cuts in direct taxes and widening fiscal deficits, the authorities were thus generally reluctant to raise indirect taxes because of the inflationary implications of such a move.

FISCAL DEFICITS AND DEBT ACCUMULATION

The implications of sustained fiscal deficits for economic performance have received a great deal of attention and aroused controversy

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[4]The relationship between personal income tax structures and economic growth in six major industrial countries is analyzed in Vito Tanzi, *The Individual Income Tax and Economic Growth: An International Comparison* (Baltimore: The Johns Hopkins Press, 1969). The study concludes that there is a significant negative relationship; that is, the growth rates are lower for countries that rely most heavily on the individual income tax as a source of revenue.

over the past several years. The subject is well known and will not be reviewed here at any length. However, a brief overview of the main issues will serve as a useful background against which to view experiences in individual countries in the group.

The most obvious implication of large and sustained fiscal deficits is the associated debt accumulation and the resulting claims on present and future budgetary resources. As was seen in Chapter 2, the debt burden rose in most of the smaller industrial countries over the period and, in certain instances, quite substantially. For some countries in the group, a continuation of this trend is foreseen over the next several years unless drastic counteractive measures are introduced. This is true, in particular, where the fiscal deficit has assumed a structural character and would persist even if cyclical conditions returned to normal. Those countries that experienced the largest debt accumulations over the period, such as Ireland, Belgium, Denmark, New Zealand, and Sweden, will thus be facing difficult fiscal adjustment problems over the next several years. Sustained deficits have pre-empted a growing proportion of budgetary resources, imposed burdens on future generations, and, from the point of view of economic management, implied growing inflexibility in fiscal systems and restrictions on the scope for pursuing fiscal policy in an efficient manner. Although in certain instances, like Iceland, Ireland, and New Zealand, the debt-servicing burden was somewhat lessened as inflation eroded the stock of outstanding debt, this development is likely to have had undesirable consequences from the point of view of equity.

Another implication of fiscal deficits is their effect on the price level and balance of payments. Fiscal deficits may, depending on the method of financing, add to inflationary pressures via direct cost and demand impact and through the monetary repercussions, thus exerting pressure on the current account of the balance of payments. Such influences characterized fiscal developments in most countries in the group, and the problems tended to intensify as the period progressed, not only because large deficits persisted and in several cases widened, but also because the deficit tended increasingly to be financed by external borrowing or by domestic monetary sources. Although most countries in the group had to struggle with this problem, it was a particular cause for concern in a country like Australia, where inflation was already the major economic problem. It was aggravated by the monetary implications of a persistent large public sector deficit and the inflationary expectations it generated. The liquidity impact of the deficits has also

severely complicated the task of monetary management in a number of countries, including Finland, Iceland, Ireland, New Zealand, Norway, Spain, and Sweden. In Spain the problem assumed an added significance, as monetary policy is the major instrument of short-term demand management.

While fiscal deficits added to inflationary pressures in a number of countries, inflation in turn affected the budgetary outcome in different ways; it may be of interest to note the experiences of three countries in the group for which information on the subject is available. In Belgium in the mid-1970s, inflation itself rendered expenditure restraint difficult, not only because of indexation of significant expenditure components, but also because the responsive tax system made it easier to finance new expenditures. In Denmark expenditure was more affected by inflation than revenue. Because of the indexation of expenditure components, the importance of specific excise and other taxes, and the indexation of tax scales and deductions, the fiscal position thus tended to deteriorate as a result of inflation. In Iceland, by contrast, inflation automatically influenced revenue more than expenditure in the early part of the period, owing to a responsive tax system that relied on ad valorem indirect taxes. However, a proliferation of indexation mechanisms has since eroded this stabilizing feature of the fiscal system.

It is relevant here to consider the effectiveness of a deficit-creating fiscal stimulus, which over the period was a typical policy response to increasing slack in economic activity. The impact of such measures is reduced through counteracting leakages into imports or increases in private savings. In the former case, much of the fiscal stimulus to the domestic economy will be neutralized, since part of the added demand will be directed at imports. It has been estimated that for a typical European country, taking such action in isolation results in about 40 percent of the potential output-generating effect being absorbed by imports.[5] The smaller industrial countries are characterized by relatively large external sectors, and because of the low value of the domestic multipliers, fiscal stimulus is presumably still more restricted than in a typical European case. Private savings might increase as a result of a fiscal stimulus, leading to or increasing deficits, if private households equate government spending with their own consumption. Then private consumption would be cut accordingly and savings increased.

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[5] Robert W.R. Price and Jean-Claude Chouraqui, "Public Sector Deficits: Problems and Policy Implications," *OECD Occasional Studies* (Paris) (June 1983), p. 27.

Considerations of future needs for increased taxation necessitated by sustained fiscal deficits might also induce increased personal household savings. It must be said, however, that these propositions do not rest on very firm foundations, and the impact of fiscal stimulus on private savings is fairly indeterminate.

The impact of fiscal deficits on economic activity is commonly analyzed in terms of crowding-out effects, of which there are two kinds—real and financial.[6] Real crowding out may occur when government action pre-empts real resources, such as manpower and materials, but this need not necessarily be associated with deficit financing. Financial crowding out is widely believed to be a major cause for limited effectiveness of fiscal policy in stimulating economic activity. The argument relies essentially on the perceived effect of noninflationary deficit financing on interest rates and the curtailing repercussions on private sector investment. Although fiscal stimulus may under certain conditions lead to higher overall domestic demand, private borrowers may nonetheless be "crowded out" of the capital market through higher costs of borrowing. Under conditions of high capital mobility and floating exchange rates, the higher rate of return to investors is also likely to have an adverse impact on the international competitiveness of the economy, as capital inflows would tend to have an appreciatory impact on the exchange rate. As a consequence, activity in the export- and import-competing sectors would contract. If increased government spending were financed by money creation, it has been argued that this would lead to an upward revision of inflationary expectations, as households attempted to maintain their real money balances. This would result in an upward pressure on interest rates, with a detrimental impact on private sector investment.

Several other mechanisms exist through which crowding out might be expected to take place, in addition to those described above. The results these mechanisms might produce depend in large measure on the specifications assumed with regard to private financial savings behavior and the institutional setup and functioning of financial markets.[7] There is also considerable uncertainty about the relative strength of financial crowding-out effects, on the one hand, and the

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[6]The counteracting impact of leakages into imports and increases in private savings discussed above is sometimes defined as a crowding-out effect. See Price and Chouraqui, pp. 27–28.

[7]For a further discussion of this issue, for example, see Price and Chouraqui, pp. 28–31.

stimulating effects of increased public spending, on the other. The significance of institutional factors and economic characteristics such as external sector size suggests a need for caution in making generalizations in this regard. Examining individual countries would probably be a more rewarding approach. However, since available evidence does not permit such an ambitious undertaking here, this study will limit itself to a brief discussion of some major aspects of crowding out, based on individual country experience.

Financial markets in the smaller industrial countries are in different stages of development and are subject to different exposure to international capital markets. Those differences appear to have significant implications for crowding-out mechanisms. In countries such as Australia, Belgium, the Netherlands, and Sweden, where the capital markets are highly developed, some financial crowding out has resulted from the application of the mechanisms described above. In Belgium and the Netherlands, both of whose public sector borrowing requirements have been growing, nonmonetary financing of the deficit by the sale of bonds has put upward pressure on long-term interest rates and has had an adverse impact on business investment. In Sweden a sharp increase in the government borrowing requirement exerted upward pressure on interest rates, and industrial investment suffered. The authorities endeavored to avoid the crowding out of industry from the capital market by limiting government borrowing outside the banks, but this led to growing monetary financing of the fiscal deficit, as well as excessive monetary expansion.

The crowding-out effect of the mechanisms is not so clear-cut where domestic market forces are less effective in determining interest rates. In Austria and Denmark, for example, the impact of fiscal deficits on interest rates is limited, as the latter are determined by external rather than domestic considerations. Exchange rate considerations in Austria have helped keep the deficits from crowding out private investment, although the depressed state of economic activity and limited private sector demand for credit may have also contributed. In Denmark monetary policy was preoccupied with preserving the foreign reserve position, which implied high interest rates to induce capital inflows needed to adequately finance the external deficit. Although crowding-out effects may have been felt, their connection with the fiscal deficit was not immediately obvious. In other countries, such as Norway and Spain, funds are acquired by the public sector to a certain extent through captive arrangements; and in others, interest rates are administered by

the authorities and do not reflect market forces. This practice is known to have resulted in the existence of negative real interest rates over an extended period.

EMPLOYMENT POLICIES

Government policies supporting employment have assumed an enhanced role in the postwar period, and fiscal measures have been an important ingredient in the overall strategy. While previously, policies of unemployment insurance, employment exchange, and public relief work were pursued in many countries, the 1960s witnessed a spread of strategies that involved training and retraining and similar devices to increase labor mobility. In the 1970s and early 1980s, with rising unemployment and growing structural adjustment problems, the emphasis shifted to job maintenance and job creation in private industry, and a number of countries adopted the policy of relieving unemployment through increased public sector absorption of labor. At the same time, employment policies became more permanent and there was a growing tendency to introduce selective employment-supporting measures to favor certain kinds of industry and labor or to maintain regional balance.[8] Government support to industry has in many countries been closely connected with employment policies.

Since the early 1970s most of the smaller industrial countries have pursued active employment policies of a protective or preventive nature, with an emphasis on protecting the workers involved. The extent of employment support by the government has varied, however, with Australia perhaps placing most emphasis on the role of market forces and thereby minimizing direct government involvement. The countries have had mixed results on this front. Whereas a few managed to prevent the rate of unemployment from exceeding 4 percent of the total labor force for the major part of the period covered (Austria, Iceland, Luxembourg, New Zealand, Norway, and Sweden), other countries suffered unemployment rates in excess of 8 percent over an extended period (Denmark, Ireland, and Spain). As the employment situation at any given time is determined by the general economic environment, which in turn is influenced by a multiplicity of external and internal factors, it is inherently difficult to assess the effectiveness of

[8]For a historical overview of employment policy strategies, see Robert B. McKersie and Werner Sengenberger, *Job Losses in Major Industries: Manpower Strategy Responses*, Chapt. IV (Paris: Organization for Economic Cooperation and Development, 1983).

fiscal measures in this regard. However, the following examples provide an illustration of some of the major government schemes for sustaining employment since the early 1970s; subsequently, certain implications of these policies for economic performance will be considered.

Increased public sector employment. Several countries pursued a policy of increasing public sector employment to ameliorate the unemployment problem, for example, Belgium, Spain, Denmark, and Sweden; the last two emphasized local government employment in this regard with the support of special grants from the central budget. Public sector absorption of labor was especially pronounced in Sweden over this period: the share of the government services sector in total employment rose from 20½ percent to 29 percent between 1970 and 1978, compared with a rise from 12 percent to 14½ percent on the average in industrial countries for which data are available.[9] It is also relevant that Austria has traditionally followed a policy of having the nationalized industries absorb labor in times of depression.

Direct budgetary outlays to create or sustain employment. This is probably the most common employment-supporting device adopted by this group of countries. Direct budgetary outlays for this purpose took various forms, most frequently, capital expenditure for public works projects, relief works or building programs, or specific employment-creating schemes (Ireland, New Zealand, Sweden). Some countries (Australia, Finland, the Netherlands) emphasized employment at the regional level by increasing advances for local or state government investment.

Retraining. Central government grants for training and retraining in the local government and private sectors served the objective of facilitating labor mobility in an environment of structural change in the derived demand for labor. In some instances, special emphasis was put on training disabled persons and the long-term unemployed. Although many countries in the group adopted this approach at different times within the period covered, it was most pronounced in Denmark, Finland, the Netherlands, Norway, and Sweden.

Compensating for shorter working hours. Belgium set up a program to support firms that had agreed to cut working hours in the form of credit to finance additional hiring; and Luxembourg granted subsidies to firms to partially compensate employees that had been put on short-term work. The purpose of these schemes was essentially to avoid the

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[9] Organization for Economic Cooperation and Development, *Economic Surveys: Sweden* (April 1980), p. 42.

cost of dismissal and rehiring and to enable employers to keep experienced workers, while at the same time reducing the earnings loss of employees during short-time work.

General incentives for job creation. Such incentives took various forms and affected both sides of the budget. Several measures of this kind that had the broader objectives of general economic stimulus have already been discussed in previous sections; the stimulating objective of the examples mentioned here was more confined to employment. Incentives for capital expenditures that would sustain employment in particular were granted in Ireland. In Luxembourg, wage costs were subsidized (20 percent of these costs) to mitigate the effect of structural change on the employment situation, especially in the declining steel industry. In Austria interest costs were subsidized; and in Denmark interest costs on loans for residential housing were reduced. Also in Austria, tax credits were granted for certain types of employment-creating investments, and in Finland and Spain, employers' social security contribution rates were reduced as a means of reducing factor cost distortions against labor. Norway sought to sustain employment in separate parts of the country by differentiating employers' social security contributions by region.

Conditional employment-supporting measures. Schemes that required a minimum level of employment to be maintained by firms receiving grants were practiced in the Netherlands, Norway, and Sweden. In the Netherlands, grants were made available to the clothing industry provided that employment was kept at a specified minimum level. In Norway, a special stock financing scheme was operated whereby firms received subsidies to cover a certain proportion of the increase in stocks on condition employment was not reduced. And in Sweden, a temporary stock support scheme whereby enterprises received grants amounting to 20 percent of the volume increase in their inventories was conditional upon the maintenance of employment levels by the enterprises over the grant period. An additional measure under this category practiced in Luxembourg to encourage labor mobility was the payment of a bonus for workers who voluntarily transferred to new industries.

Grants to encourage recruitment of special kinds of labor. In order to directly alleviate the unemployment problem, Finland, Ireland, and the Netherlands paid special grants to employers who hired from the unemployment register. The Netherlands also granted subsidies to enterprises that employed teenagers.

Retirement schemes. The introduction of early retirement schemes or flexible retirement options in countries like Belgium, Denmark, Luxembourg, and Sweden, besides serving a broader social objective, also was presented in an employment policy context that aimed at alleviating unemployment through the removal of older workers from the unemployment register.

Evidence suggests that some of these schemes had a fair amount of success, such as mobility schemes and training programs. The same holds true for certain short-term job creation or preservation schemes, especially when combined with training programs, e.g., the Swedish scheme that covered a quarter of a million people in 1978 and obliged employers to provide training for the subsidized workers.[10] Job creation, along with many other employment-sustaining programs, was originally intended to be temporary to help firms and industries over cyclical downturns in the level of economic activity and thereby minimize the social cost of employment dislocation. As mentioned, these schemes tended to assume a more permanent character, with adverse repercussions on overall long-run economic performance. This experience was fairly general among the smaller industrial countries, although it was most marked in countries that had a combination of high employment policies and large structural change, like Austria, Norway, and Sweden. Policies to absorb labor in the public sector to alleviate unemployment and selective measures to support ailing industries exposed to foreign competition and to preserve regional balance contributed to a slowdown in labor mobility; this potential inefficient allocation of resources tended to retard the adjustment process, which otherwise might have taken fuller advantage of the production potential of the countries concerned. Of course, these adverse long-run repercussions on economic performance have to be weighed against any social benefits these policies may have produced.

SOCIAL SECURITY SCHEMES

In almost all countries in the group, subsidies and other current transfers have been the most dynamic element in public expenditure growth as discussed in Chapter 2. Unfortunately, the basic statistical source used, *Government Finance Statistics* (*GFS*), does not permit a disaggregation of this expenditure category, so the following analysis

[10]Organization for Economic Cooperation and Development, *The Challenge of Unemployment* (Paris, 1982), p. 109.

has to rely on less comprehensive data. It is clear, however, that within this category expenditure on social security is the major component and old age and disability pensions have the heaviest weight. Unemployment compensations form another subcategory and although this type of expenditure is a relatively small part of total government spending, it increased rapidly over the period. The generosity of entitlement programs has in some instances reached a level that has caused concern over their potentially adverse repercussions on the economy. A few examples of exceptionally generous schemes are provided here, and the main economic implications of the expansion of social security entitlements are considered, with emphasis on old age pensions and unemployment compensations.

In the Netherlands the general social security system includes a guaranteed minimum income equivalent to US$750 a month. Also, taking account of the hidden unemployment element in this scheme, the estimated proportion to the potentially active population that is not working is as high as 20 percent. In neighboring Belgium, where social benefits, notably unemployment compensation, have become more generous than in most other countries, it is estimated that over 80 percent of households receive support from the system and that one quarter of all households are entirely dependent on it financially. In Sweden, traditionally a country with intensive social insurance, the effect of a supplementary pension scheme, which became fully effective in 1979 after a 20-year phasing-in period, increased the pension to 65 percent of the individual's income over the best five years, with an upper limit amounting to the equivalent of about US$17,500 a year. All new pensioners from 1979 qualify. The generosity of unemployment compensations has also reached unusual proportions in Denmark; benefits amount to 90 percent of earnings up to the equivalent of approximately US$33 a day payable from the first day of unemployment for six days a week.[11]

Social security schemes may exert an impact on the economy in various ways. The most frequently studied are the effects of pension schemes on employment and household savings and of unemployment compensations on work incentives. Studies of the impact of pension schemes on labor supply and retirement decisions are not conclusive. While some maintain that there is an inverse relationship between the

[11] United States, Department of Health and Human Services, *Social Security Programs Throughout the World, 1983* (Washington: Government Printing Office, 1984).

two, that is, improved pension schemes reduce labor supply and increase incentives to retire, the impact is considered relatively modest.[12] Others have come to the opposite conclusion. Thus, an OECD cross-country study found little evidence of a systematic relationship between participation rates, on the one hand, and eligibility and transfer ratios, on the other.[13] The same inconclusiveness is attached to the impact of pension schemes on household savings. Whereas earlier studies purported to have found a significant negative relationship between old age pension schemes and private savings, later empirical work failed to consolidate such findings. As the OECD study just quoted concluded, ". . . it would appear that the effects of social security provision on savings remain ambiguous on the basis of both theoretical reasoning and empirical investigation."[14]

It would appear, however, that the empirical evidence is not always easily reconciled with these inconclusive findings. Thus, the aging structure of the population, which is a fairly general characteristic of demographic developments over the period, did not entail a concomitant increase in the participation rate of older people in the labor force as might have been expected. On the contrary, this proportion declined over the period. This decline has been attributed to a general increase in the wealth of older people, some of which has surely been generated by increased real pensions. Another contributing factor is the adoption of early retirement schemes in a number of countries in the group, as already discussed. Such increases in generosity would appear to support the presumption that improved pension schemes reduced the participation rate of older workers in the labor force in the 1970s. However, it is unlikely that during this period of severe slack in economic activity in most of the countries, such a withdrawal adversely affected the performance of the economies, even if it imposed additional strains on government budgets.

Elsewhere in this study references have been made to an adverse economic impact of high unemployment compensations on employment. As the generosity of unemployment benefits increases, the "moral hazards" inherent in income maintenance schemes become greater for employable people. The other side of the coin is that

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[12] Sheldon Danziger, Robert Haveman, and Robert Plotnick, "How Income Transfer Programs Affect Work, Savings and the Income Distribution: A Critical Review," *Journal of Economic Literature*, Vol. 19 (September 1981), pp. 975–1028.

[13] Saunders and Klau, pp. 141–142.

[14] Saunders and Klau, p. 146.

generous benefits induce increased female participation in the labor force, which, under the adverse economic conditions prevailing for a large part of the period, added to registered unemployment. The Netherlands, Belgium, Denmark, and Sweden have already been mentioned as typical examples of countries with generous social security programs. In all these countries concern over the potentially adverse impact of high unemployment benefits on work incentives and economic growth has been growing. In addition, in New Zealand, unemployment benefits have been a growing incentive to register as unemployed, which has had a strong impact on the female participation rate, accounting for the entire increase in employment between 1976 and 1981. A similar, if less pronounced, increase in the female participation rate took place in Denmark and is considered to have arisen from generous unemployment compensations.

Since social security outlays contributed significantly to the explosive growth of government expenditure in most countries in the group, the impact of large and sometimes widening fiscal deficits on the economies is an important corollary. The economic implications of fiscal deficits were discussed earlier in this chapter, but to conclude this section a few additional reflections on factors that may have driven the generosity of some programs further than intended seem in order.

As discussed in previous chapters, increases in real benefits and extension of their coverage were a major cause of the explosive growth of social security expenditure. While the general relief and redistributional objectives of this policy enjoyed wide support in the countries concerned, it appears that the extent of generosity of particular schemes in some instances went beyond original intentions. One reason lies in overoptimistic assumptions about future growth rates of the economy that tended to be based on projections of trends experienced in the more prosperous 1950s and 1960s when many of the schemes were founded or improved. A second reason may derive from insufficient attention to demographic developments such as the aging structure of the population, larger female participation rates, and changes in migration patterns. A third reason may be that the legal provisions frequently did not entail immediate costs at the time of enactment, so that the financial implications were not fully perceived. However, even when it was subsequently realized that the cost implications of social security schemes could not be reconciled with growth prospects of the economies—that is, financed by economic growth—once entitlement programs were established or their generosity increased, a failure to

stabilize, let alone reverse, growth trends was one of the major problems facing fiscal policy.

INCOMES POLICIES

This section deals with the interaction of fiscal and incomes policies in the smaller industrial countries over the period covered. Beginning with a brief overview of the objectives of incomes policy and the main approaches followed, the section goes on to review fiscal incomes policy measures introduced in individual countries and ends by considering the effectiveness of such measures and their wider implications.

Incomes policies generally served the immediate purpose of combating inflation and alleviating the unemployment problem. However, in countries like Denmark and New Zealand these policies were an integral part of strategies to bring about external adjustment; in other countries such as the Netherlands and Norway, redistribution of income in favor of lower income groups was a declared objective pursued within the framework of incomes policy. Persistent inflation and unemployment persuaded authorities in many countries that the imbalances could not be eliminated through demand-management policies alone, and attention was progressively directed to the cost side. Almost all countries in the group adopted some form of incomes policy in this context, although approaches varied widely with respect to their permanency, the extent and formalization of government involvement in the wage bargaining process, and the comprehensiveness of the macroeconomic base on which incomes policies were founded. Thus, in Austria and Norway, incomes policies were based on a broad social contract, or "social partnership", and these countries managed to maintain such policies over an extended period; most other countries, however, owing to insufficient social consensus and unfavorable institutional conditions, had to contend with temporary incomes policies and associated phasing-out problems. Also, formal government involvement was intense in countries like Finland, Iceland, the Netherlands, and Norway; whereas in Belgium, and in Sweden until 1978, for example, formal government involvement was minimal. Austria, Norway, and the Netherlands represent cases where tripartite agreements were well coordinated with macroeconomic policy; this also holds true for Sweden, where an economic model developed jointly by the central federations of labor and management has had a considerable influence on collective bargaining. This link was weaker in most other countries.

Although incomes policies date back to the early post-World War II period, it was not until the 1970s that fiscal incomes policy measures

came to play a prominent role. This increased role reflects growing awareness of "tax-push" inflation and explains the widespread use of income tax reductions in endeavors to ensure moderate wage settlements. Otherwise, the form of fiscal and other official measures to influence wage developments varied considerably among individual countries. The most direct intervention consisted of mandatory controls in the form of temporary wage or price freezes, or a combination of the two. In New Zealand, for example, wages and other private incomes were effectively controlled during 1974–77. In 1976 Spain introduced tax reductions to make the continuation of wage controls more acceptable, and from autumn 1978 until the end of 1979, Norway implemented a complete wage and price freeze. Belgium and the Netherlands also imposed temporary wage controls over the period. Other countries have intervened by stipulating maximum wage increases at certain intervals within a fixed period either by legislation or as guidelines, most recently, Denmark and Iceland. However, the strictness with which such policies have been implemented has varied.

As indicated, tax reductions are probably the most widely used fiscal contribution to incomes policy. In order to ensure moderate wage settlements, a large majority of countries in the group implemented a series of reductions in the personal income tax over the period in the form of rate reductions, increases in exemptions, and indexation of tax scales and deductions. In addition, employers' social security contributions, which tended to distort the cost of labor against other factor costs, were reduced explicitly in an incomes policy context in countries like Belgium, Norway, Spain, and in Finland where employees' contributions were also reduced. Furthermore, temporary reductions in indirect taxes to slow down the rate of inflation were carried out in Denmark, Finland, Ireland, and Sweden.

On the expenditure side, increases in social security benefits, including pensions, child and maternity allowances, and unemployment benefits, were incorporated in the government's incomes policy strategy in a number of countries, notably Finland, Iceland, and Norway. The same countries, with the addition of New Zealand and Spain, resorted to increases in consumer subsidies to counteract inflation, frequently within an incomes policy framework. In many countries a contribution to incomes policy on the part of the government consisted of commitments to secure a high level of employment. This approach was usually expressed in general terms as a major objective of overall economic policy, whereas in certain instances such commitments

appear to have played a more specific role in wage settlements, for example in Austria, as have employment guarantees in the Netherlands and Ireland. Also, in a 1981 tripartite agreement in Spain, the Government committed itself to promoting the creation of a certain number of jobs against wage restraint. Finally, a unique approach adopted by Denmark is the payment by the central government of a portion of indexation compensations due to workers into blocked individual accounts with the labor market pension fund.

Assessing the effectiveness of incomes policy is fraught with problems. The success or failure of the policy depends on a variety of social, political, institutional, and economic factors that are likely to differ among countries and change over time within individual countries. The sociopolitical factors have an important bearing on the extent to which a social consensus is achievable. Institutional factors influence the degree of centralization of collective wage agreements, but decentralized agreements reached at different times are liable to undermine the effectiveness of incomes policy through wage emulation and catch-ups. Economic factors relate to the openness of the economy and the impact of external impulses on the price level, the extent to which incomes policy is formulated in a macroeconomic context, the role assigned to complementary fiscal and monetary policies, and the exchange rate policy pursued. Austria's favorable experience with incomes policy, for example, may be explained by an advantageous constellation of these factors; to a certain extent this is also true of a relatively effective incomes policy in Norway and in Finland after 1977. Other countries in the group have had mixed results. Thus, Denmark and Iceland have encountered persistent difficulties in establishing a sufficiently strong social consensus despite government involvement in income formation and a substantial use of fiscal incomes policy measures.[15]

In view of the openness of the economies under consideration, it is relevant to note the potentially favorable interaction of incomes and exchange rate policies. Under a relatively stable exchange rate regime, incomes policy may assume an enhanced role in keeping wage increases to a rate that preserves profitability in the exposed sector of the economy. Austria provides a vivid manifestation of such a role assumed

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[15] For an overview of incomes policies in six of the smaller industrial countries, see John T. Addison, "Incomes Policy: The Recent European Experience," in J.L. Fallick and R.F. Elliott, eds., *Incomes Policies, Inflation and Relative Pay* (London: George Allen and Unwin, 1981), pp. 187–245.

by incomes policy. In a setting of strong social consensus, exchange rate considerations figure prominently in deliberations of the social partnership. The labor market partners have appreciated the hard-currency policy pursued by the authorities, which has enhanced the effectiveness of incomes policy. However, as is the case with other aspects of incomes policy, Austria's experience is unusual among the smaller industrial countries.

While fiscal measures in certain respects effectively moderated wage settlements, especially in countries where the social consensus was strong and institutional and economic factors were favorable, these measures had wider and usually detrimental implications in other areas. As mentioned, fiscal incomes policy measures, whether on the revenue or expenditure side, generally weakened the budgetary position and thus compromised demand management; moderation in wage claims was in varying degrees offset by increased demand pressures. In this complex issue it is not possible to determine the net impact of such measures on price developments in the longer run. Econometric examinations of the effectiveness of incomes policies, including the impact of fiscal incomes policy measures, have not produced any conclusive results, one reason being disagreement among model builders about the determinants of the inflation process. An additional difficulty relates to the modeling of price expectations, which usually figures prominently in discussions of wage equations, because inflationary expectations are not observable.[16]

Apart from the demand pressure emanating from fiscal incomes policy measures, an intensive application of indirect tax reductions and increases in subsidies is liable to distort the allocation of resources. Moreover, incomes policies have a tendency to reduce wage differentials more than intended or more than is sustainable, and this may cause a destabilizing reaction that gives added impetus to wage drift.[17] Finally, ill-conceived strategies, such as premature announcement of fiscal incomes policy measures, including commitments to maintain a high level of employment and to reduce taxes, can compromise the bargaining position of governments and complicate the achievement of moderate wage settlements.

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[16]For further discussion of these issues, see, for example, Palle Schelde Andersen and Philip Turner, "Incomes Policy in Theory and Practice," *OECD Occasional Studies* (Paris) (July 1980), pp. 33–50.

[17]Andersen and Turner, pp. 43–44.

6

Summary and Conclusions

The two oil crises and persistent global recessionary conditions had far-reaching repercussions on budgets and in many ways shaped fiscal policy in the smaller industrial countries over the period covered. Although policy priorities differed among these countries, there was one overriding similarity in fiscal policy response to these external impulses, namely, a defensive stance intended to cushion their adverse impact on the national economy, especially on employment and economic activity and on living standards in general. The intensity of policy responses varied from one country to another for various reasons. Thus, the action required differed according to the size of the external sector, or openness of the economies, and also because domestic energy production varied substantially among the countries. Also, political ideologies with regard to the proper role of the state and the reliance on the market mechanism differed among these countries and sometimes changed within individual countries with changes of government. Moreover, the likely duration of the recession following the first oil crisis was perceived differently and, consequently, so was the appropriate degree of fiscal stimulus.

The policy response to the first oil crisis and the ensuing world recession was generally to shift the stance of fiscal policy in a highly expansionary direction. Although initially intended to be temporary, the persistence of recessionary conditions caused a prolongation of this posture, which entailed, with a few exceptions, sharp increases in government expenditure in relation to total output, mounting tax burdens, and widening fiscal deficits. During the latter half of the period, policy was increasingly directed at the containment or reduction of these imbalances, as the large-scale absorption of resources by the public sector was widely seen as having an adverse long-term impact on

economic performance. However, the problem of achieving the needed adjustment was exacerbated by rigidities in the fiscal systems that had grown over the period and severely limited the scope for fiscal action. In countries experiencing the largest deterioration in the fiscal position, the public finances had assumed imbalances of a structural character. Deficits and debt accumulation threatened to become self-perpetuating, and fiscal adjustment became an objective per se.

Despite growing efforts, limited success has been achieved in reducing fiscal imbalances. Obstacles to fiscal improvement are diverse and include elements of both an economic and a political nature. The period thus witnessed a strengthening of automatic fiscal stabilizers that tended simultaneously to trigger increased spending, notably in the social security area, and retard revenue growth. Demographic developments produced increasing claims on budgetary resources. The scope for fiscal action was narrowed by a growing tendency for future expenditure commitments to be determined by specific legislation whose budgetary burden was frequently aggravated by indexation mechanisms. Persistent fiscal deficits implied debt accumulation whose servicing requirement increasingly pre-empted budget resources. All these elements introduced growing rigidities into fiscal systems. Furthermore, there are indications that overoptimistic assumptions about the growth potential of the economy led to the setting of overambitious goals of fiscal policy, with adverse implications for the fiscal position. Lastly, the smaller industrial countries all have a system of political democracy which is often characterized by frequent changes of government. This political environment has not proved conducive to the formulation and pursuit of consistent long-term policies with clearly defined objectives, and the stance of policy tended to change frequently. There is ample evidence of inconsistent policy actions over the period that caused the impact of restrictive fiscal measures to be outweighed by subsequent measures of stimulus to promote employment and social welfare objectives. Such changes run the risk of impairing confidence in the firmness of the policy stance, with adverse repercussions on economic performance. The political element in fiscal policy thus contributed to difficulties in achieving targeted fiscal adjustment.

While the foregoing comments are fairly representative of the general situation, fiscal performance nonetheless varied markedly among individual countries. This variety applies to the expansion of the government sector, as measured by the ratio of government expenditure to GDP, and of tax burdens as well as the size of fiscal deficits and the

debt accumulation they generated. While all countries experienced tendencies toward a rapid expansion of the government sector after the first oil crisis, some reacted quickly and were successful in curbing expenditure growth, for example, Australia, Finland, Iceland, and Norway. Consequently, these countries had less need to raise revenue, and the tax burden was not a cause for particular concern by the end of the period. Other countries, including Belgium, Ireland, the Netherlands, and Sweden experienced an explosive expansion of the government sector, and tax burdens also rose steeply in these countries, especially in Belgium and Ireland. However, revenue growth did not match that of expenditure, except in Norway, which implied growing fiscal deficits elsewhere. Over the whole period, the largest government deficits were incurred by Ireland, Belgium, New Zealand, and Sweden; Luxembourg had the distinction of maintaining a surplus for the major part of the period. Ireland and Belgium had the highest government debt/GDP ratios and mounting debt-servicing burden by the end of the period; this ratio was lowest in Luxembourg and Finland.

These fiscal developments and policies had far-reaching economic implications. Analyzing their impact on the economy in any precise manner is a complicated task, however; a major problem is the issue of causation, as factors outside the realm of public finance influence economic performance and their impact is not separable from that of fiscal factors. But in many instances the direction of the impact is fairly clear. On the expenditure side, while analysis at the aggregate level does not lead to conclusive findings, there is strong evidence that separate expenditure schemes in many instances increased to an extent that exerted a harmful impact on economic performance. Thus, it was a fairly general experience that employment-creating schemes contributed to a slowdown of labor mobility and thus retarded structural adjustment and efficient resource use. Various forms of industrial support designed to protect the exposed sector of the economy against adverse external impulses and to preserve regional balance had a similar effect. An explosive growth of social security expenditure was a major cause of fiscal imbalances. The generosity of pension and unemployment compensation schemes, in particular, in some instances reached a level that caused concern over the adverse repercussions on work incentives. Also, while incomes policy in a few countries, including Austria and Finland, contributed to economic stabilization, this was not the general experience, and the fiscal contribution to incomes policy invariably entailed a substantial deterioration in fiscal positions and added to demand pressures.

While revenue in most countries increased at a slower pace than expenditure, some experienced a substantial increase in the tax burden. Personal income taxes and their progressivity affected work effort and initiative adversely in countries where this tax was highest, such as Belgium, New Zealand, Norway, and Sweden. In some of these countries, the high personal income taxes encouraged tax avoidance and evasion, contributed to wage-push pressures, and discouraged savings. Social security contributions, a significant revenue source in countries like the Netherlands, Spain, and Sweden, increased rapidly over the period and added significantly to labor costs. This led to a distortion of factor costs against labor and aggravated the cost position in a depressed enterprise sector.

Finally, the large and persistent fiscal deficits implied debt accumulation whose servicing constituted increasing claims on present and future budgetary resources. There is evidence also that in countries like Australia, Belgium, the Netherlands, and Sweden, where financial markets are well developed, fiscal deficits exerted upward pressure on interest rates, with an adverse impact on business investment and economic growth. Such financial crowding-out effects were doubtless experienced in varying degrees in other countries in the group, although the imperfection of financial markets and external influences on interest rate determination make analysis of the crowding-out effects of fiscal deficits in these cases inconclusive.

One lesson that emerges from the different experiences in the fiscal field is that the degree of expenditure restraint would appear to be a significant determinant of overall fiscal performance (see Table 6.1). The rate of expansion of the government sector thus tended to be positively correlated with the rate at which deficits widened, debt ratios expanded, and debt-servicing burdens increased. Also, with a few exceptions, notably Norway and Spain, countries with the smallest government sector at the beginning of the period tended to experience the smallest expansion of that sector over the period in terms of percentage points of GDP. On the other hand, the relation between government sector expansion and growth of the tax burden exhibited, to some extent implicitly, a highly irregular pattern.

The scope for exercising expenditure restraint depends on a variety of factors and the most important ones are probably not economic in nature. Among countries that were most successful in restraining expenditure growth, it appears that certain attitudes, which had evolved through long and complicated historical processes, had an important

Table 6.1. Smaller Industrial Countries: Selected Fiscal Indicators

(Central Government, Percentages of GDP)

	Government Sector Expansion 1972–82 (Percentage Points)	Deficit in 1982	Annual Average Deficit 1972–82	Interest Payments 1982	Debt Ratio 1982	Government Sector Size 1982	Tax Burden 1982
Norway	2.4	0.8	−2.8	2.4	26.5	41.8	42.6
Australia	3.7	−0.3	−2.2	1.9	22.7	28.3	28.0
Luxembourg	3.7	0.5	1.1	0.7	4.7	35.8	34.7
Finland	5.1	−2.1	−0.8	0.9	12.3	30.6	28.6
Iceland	5.4	−2.9	−3.0	2.4	31.4	35.9	32.9
Austria	9.8	−4.4	−3.1	2.2	30.0	39.9	35.5
New Zealand	11.2	−7.4	−5.9	4.6	58.2	42.2	34.8
Spain	11.8[1]	−7.1[2]	−2.4[1]	0.6[2]	19.4[2]	32.3[2]	25.3[2]
Netherlands	12.8[3]	−7.6	−3.5[3]	3.2	39.4	58.8	51.3
Denmark	13.2	−8.3	−1.4	4.6	59.2	45.2	36.9
Sweden	13.5	−9.8	−4.7	4.6	45.4	48.9	39.0
Belgium	17.1	−12.2	−6.6	7.7	73.9	56.9	44.7
Ireland	21.1	−15.2	−11.2	9.1	108.7	57.8	42.6

[1] 1972–81.
[2] 1981.
[3] 1973–82.

bearing on the pursuit of fiscal policy. In some instances, these attitudes generated national cohesion that ensured sufficient acceptance of short-term material sacrifices against longer-term gains, and in other instances, fiscal prudence was equated with national security. There is also evidence that ideological persuasion concerning the proper role of the state caused a reversal of an ongoing process of increased government sector absorption of resources. While the nature and strength of such attitudes varied among the countries concerned, they generated in each case the required fiscal discipline to keep government sector size to more manageable proportions.

Finally, it should be reiterated that the main objective of this study has been to provide information and analysis that could enhance knowledge and understanding of public finances and the conduct of fiscal policy in this group of countries. For this reason, the scope of issues addressed has been fairly broad. It is hoped, however, that the study will provoke thought and will direct attention to separate issues that deserve more thorough research and analysis.

PART II

DEVELOPMENTS IN INDIVIDUAL COUNTRIES

Introduction

This part of the study serves as a background to the comparative analysis in Part I. It traces some of the prominent features of fiscal developments in the 1970s and early 1980s in 13 of the smaller industrial countries.[1]

In the analysis of fiscal developments and policy issues in these countries, a uniform approach is taken as far as individual conditions permit. Each country study is divided into five similar sections. The first accounts for overall economic developments over the period in broad terms, in order to indicate the general background against which fiscal policy was conducted. The next three sections analyze changes in expenditure, revenue, and the fiscal balance, both in regard to the size of these fiscal aggregates in relation to gross domestic product (GDP) and to changes in the composition of individual expenditure and revenue categories and of sources of deficit financing. The main causes of these developments are considered. The section on fiscal balance also indicates the size of government debt relative to GDP and of the external component of the debt.

The final and main section deals with fiscal policy issues. Because only the central government is covered, the extent of its role in the pursuit of overall fiscal policy is outlined by a description of its relative size within the general government sector, its relationship with local governments in regard to policy formulation and implementation, and its command over other public entities in pursuing policy objectives. Some technical aspects of budgeting in terms of forecasting techniques and assessment of the fiscal impact and, in some cases, their actual policy relevance are also considered. The section cites major aims of fiscal policy as announced by the authorities, how these may have altered with changing economic and political conditions, and what principal measures were taken to attain the stated objectives. The

[1] Switzerland, a nonmember of the Fund, is the fourteenth country in this group and is not discussed in the study.

section concludes with a brief overview of developments over the period, and considers some major implications of past fiscal policies and the policy issues that are likely to confront the authorities in the near future.

1

Australia

Compared with most of the smaller industrial economies, Australia has a small external trade sector—foreign trade amounts to approximately 15 percent of GDP. Although this and abundant energy resources have acted as a buffer to external shocks, the authorities have nevertheless been faced with the task of reducing fundamental imbalances in the economy that had developed in the first half of the 1970s. Somewhat paradoxically, these developments can be traced in part to the discovery of vast mineral resources in the late 1960s and the improved prospects for exports, which implied an exchange rate that restrained activity in the manufacturing industry. Also, and more important, a wage explosion in the 1973–75 period resulted in declining profit shares, and in subsequent years the authorities pursued a restrictive economic policy to restore balance.

These developments, together with weak foreign demand, contributed to a low growth rate of GDP throughout the period, averaging less than 3 percent a year. At the same time, the rate of unemployment rose steadily from 2½ percent to 7 percent from 1972 to 1982. The discovery of mineral resources induced capital inflows that triggered an inflationary spiral, the breaking of which has been a challenge to economic policy since the mid-1970s. Inflation rates exceeded 15 percent in both 1974 and 1975, as a result of the wage explosion and the direct external oil price impact. Since 1977 annual inflation rates ranged between 8 percent and 11 percent. After recording surpluses in 1972 and 1973, the external current account swung into deficit in the following year when domestic demand soared. Subsequently, the current account was in deficit every year, reaching a high of just over 5 percent of GDP in 1982. Despite the Australian authorities' seemingly successful containment of public expenditure growth, a fiscal deficit has been recorded in every year of the period, ranging from 0.3 percent to 5 percent of GDP.

EXPENDITURE

Commonwealth government expenditure rose sharply as a proportion of GDP in 1975, or by 5 percentage points to 29½ percent. This was the result of a deliberate policy to stimulate the economy and to enlarge public sector provision of various social services and participation in transportation. In 1976 a new government reversed the expansionary stance, with the result that the proportion declined until 1980. Between 1972 and 1982 the ratio of commonwealth government expenditure to GDP rose from 24½ percent to 28½ percent, which is among the smallest increases in this group of countries over the same period.

The composition of expenditure in terms of economic categories has changed considerably. Expenditure on goods and services, which accounted for 25 percent of total commonwealth government expenditure in 1972, had declined to less than 22 percent by 1982, while subsidies and other current transfers increased their share in the total from 47½ percent to 63 percent during the same period. This change in emphasis was in part brought about by the "New Federalism" policy pursued since the mid-1970s. The policy aimed at increasing the Commonwealth Government's financial contribution to the states in the form of general purpose grants. Such transfers amounted to 27 percent of total expenditure in 1982, having risen from 19 percent in 1972.

Interest payments on government debt declined as a proportion of total expenditure from 6½ percent to 4½ percent from 1972 to 1976; they have since been on the rise, and between 1980 and 1982 amounted to just under 7 percent of the total. Capital expenditures showed a declining trend in the latter half of the period. These accounted for some 6 percent of the total in 1982, compared with 10 percent in 1972. Net lending, which amounted to 10 percent to 14 percent of total expenditure up to 1975, has since declined sharply and in 1982 was 2½ percent of the total. This development represents a shift in financing of capital expenditures by authorities outside the budget. Until the mid-1970s, such capital outlays were largely financed through advances from the budget, whereas subsequently the entities concerned have increasingly financed their capital programs by own borrowing.

REVENUE

Between 1972 and 1982, total revenue of the Commonwealth Government expressed as a proportion of GDP grew moderately from 24 percent to 28 percent. This is a lower ratio than in most of the smaller industrial countries and may be explained in part by the absence, for

Australia: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	3.6	6.2	1.4	2.2	3.5	0.9	3.6	3.3	2.0	3.9	0.7
Rate of unemployment	2.6	2.3	2.6	4.8	4.7	5.6	6.2	6.2	6.0	5.7	7.1
Consumer prices, percentage changes	5.8	9.5	15.1	15.1	13.5	12.3	7.9	9.1	10.2	9.6	11.1
External current account balance as percentage of GDP	1.4	1.3	−3.0	−0.6	−1.3	−2.6	−3.5	−1.5	−2.3	−4.8	−5.2

Source: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984.

Australia: Consolidated Central Government Finances, 1972–82
(Year ended June 30)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue											
(as a percentage of GDP)	24.3	22.6	24.0	25.4	25.7	26.3	26.7	25.6	26.3	27.3	28.0
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	57.9	58.6	61.1	64.5	63.1	63.6	63.6	60.6	60.8	62.0	63.5
Social security contributions	—	—	—	—	—	—	—	—	—	—	—
Payroll (manpower) taxes	1.2	0.2	0.2	0.2	0.3	0.3	0.2	0.1	0.1	0.1	0.1
Property taxes	0.9	0.9	0.7	0.6	0.6	0.5	0.5	0.4	0.2	0.1	0.1
Taxes on goods and services	21.7	21.9	21.5	19.1	20.5	19.5	19.5	22.3	23.4	23.0	22.0
Taxes on international trade	5.1	5.3	5.1	5.7	5.7	5.9	5.1	5.6	5.4	5.2	5.2
Other taxes	—	—	—	—	—	—	—	—	—	—	—
Nontax revenue and grants	13.1	13.0	11.4	9.9	9.8	10.2	11.2	10.9	10.0	9.5	9.2
Total Expenditure											
(as a percentage of GDP)	24.6	24.3	24.5	29.4	30.7	29.6	30.4	28.9	28.1	28.1	28.3
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	25.1	24.1	23.4	20.6	19.5	20.1	20.1	20.0	20.4	21.0	21.7
Of which:											
Wages and salaries	...	...	...	...	...	...	...	...	...	...	...
Interest payments	6.6	6.4	5.6	4.9	4.3	5.7	6.0	6.7	6.8	6.9	6.8

Subsidies and other current transfers	47.6	49.8	50.2	49.1	56.2	58.7	61.0	62.8	63.4	63.2	63.2
Of which:											
Social security funds	...	...	...	...	...	...	...	...	...	...	...
Capital expenditure	9.8	9.8	10.2	11.2	10.3	8.8	7.6	6.6	6.4	6.2	5.9
Lending minus repayments	10.8	9.9	10.6	14.2	9.6	6.6	5.3	4.0	2.9	2.6	2.4
Surplus/Deficit (as a percentage of GDP)	−0.3	−1.7	−0.5	−4.0	−5.0	−3.3	−3.7	−3.3	−1.8	−0.8	−0.3
Financing:											
Abroad	−0.1	−0.2	−0.3	—	0.2	0.4	1.8	1.3	0.2	−0.1	0.3
Domestic	0.5	1.8	0.8	4.0	4.8	2.8	1.9	2.0	1.6	0.9	0.1
Monetary authorities	−2.6	−0.2	0.7	0.8	2.4	1.6	0.3	0.5	0.7	−0.6	0.1
Deposit money banks	1.0	1.2	−0.2	2.2	0.3	−0.1	—	0.5	0.3	0.5	0.2
Other[1]	2.1	0.8	0.3	1.1	2.2	1.3	1.6	1.1	0.6	0.9	−0.2
Memorandum Items:											
General government expenditure and net lending/GDP	32.3	31.7	32.2	38.2	38.9	38.8	39.2	37.9	36.9	37.2	37.6
Central government debt outstanding/GDP[2]	...	34.8	29.8	28.8	27.9	28.0	29.8	30.4	28.6	24.9	22.7

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

[1] Includes adjustments.

[2] Source for debt data: Commonwealth Government, 1983–84 Budget Paper No. 8 (includes Commonwealth and State Governments).

most of the period, of social security taxes, as a number of social security schemes are funded outside the public sector. A specific levy of 2.5 percent of taxable income was imposed in late 1976, but this health insurance tax was abolished in 1978, as was the compulsory health insurance scheme that had been introduced in mid-1975.

The financing of social benefits with general revenue has in turn resulted in heavy reliance on income taxes whose share in total revenue rose from 58 percent in 1972 to almost 63½ percent in 1982. The rise is accounted for entirely by the personal income tax, as the corporate tax declined in relative importance from 29 percent of combined income taxes in 1972 to 20 percent in 1982. The rise in personal income taxes occurred despite a series of ameliorating measures during the period, such as indexation of the tax in 1976 aimed at moderation of wage claims and rate changes to reduce fiscal drag.

The second largest revenue category consists of taxes on goods and services, with a share in total revenue of around 22 percent at the beginning and end of the period. The most dynamic element in this category is a levy on domestic crude oil imposed in 1977, which is to be progressively increased until full import parity pricing is reached. In 1982 this levy, together with other—and declining—excise duties, accounted for 15 percent of total revenue, whereas total excise duties amounted to 13½ percent of the total in 1972. Nontax revenue and grants, mainly property income, declined from 13 percent to 9 percent of total revenue between 1972 and 1982. Other taxes are less significant and have not changed much over the period.

THE FISCAL BALANCE AND ITS FINANCING

Commonwealth government finances recorded deficits throughout the period 1972 to 1982. These grew substantially to 4 and 5 percent of GDP in 1975 and 1976, respectively, partly as a result of the official policy of the Labor Government to achieve a fundamental social reform and keep employment up through increased public spending. Subsequently, a stricter policy stance was adopted at the commonwealth level, mainly through expenditure restraint, as a result of which the deficit declined to the equivalent of 0.8 percent of GDP in 1981 and 0.3 percent in 1982. It should be noted, however, that in the past few years of the period covered, the deficit of state and local authorities increased as a result of restrictions on federal funding of outlays by these authorities.

While commonwealth government deficits were small in the early years of the period, they were financed in large measure by the sale of

government securities to the private sector. In 1972–73 the aim of fiscal policy was to support monetary policy in reducing liquidity, and more was borrowed from the nonbank private sector than was needed to finance the deficit. Throughout the period, the nonbank private sector covered a significant portion of the Commonwealth Government's financing requirement. Foreign financing was resorted to in the period but not to a significant degree, except in 1978 and 1979 when external borrowing covered, respectively, one half and over one third of a large deficit. Since the mid-1970s, combined financing by the monetary authorities and the deposit money banks has often amounted to one half of the commonwealth government deficit. Government debt, expressed as a ratio to GDP, declined from 35 percent in 1973 to 23 percent in 1982 according to official sources, while the share of the external component in total debt rose from 8½ percent to 16 percent over the same period.

FISCAL POLICY

The framework. While Australia's constitutional system of government is characterized by large subnational units, the commonwealth budget is nonetheless the dominant instrument in formulating fiscal policy, owing both to the national character of the Commonwealth Government's role in managing the economy and the sheer size of its activities. In 1982 total general government expenditure was equivalent to 37½ percent of GDP, of which the commonwealth sector accounted for three fourths. More than one fourth of commonwealth government expenditure takes the form of transfers to state and local governments, amounting to almost one half of their total revenue and grants. The power of the states to impose taxes is strictly limited and the Commonwealth Government commands the most productive and elastic sources of revenue. Moreover, although the Commonwealth Government has limited direct control over outlays of other public entities, its indirect influence through controlling revenue sharing and through the Loan Council is substantial. The Loan Council, dominated by the Commonwealth Government, aims at coordinating all public sector borrowing, including borrowing for public works and housing programs at the state and local government level. The amount of commonwealth financial assistance to the states is based on agreements that are negotiated every five years. Despite the formal arrangements favoring commonwealth government dominance within the public sector, experience in the past

few years suggests that the states nevertheless enjoy a fair amount of autonomy in expenditure matters. Thus, during the period of expenditure restraint since the mid-1970s, they were able to sustain increasing expenditure levels in real terms by drawing on their own resources and securing financing of growing deficits.

In 1971 a system of three-year forward estimates of expenditure, which had been initiated in 1965, was further elaborated to include new as well as existing programs that, unlike the previous system, required ministerial endorsement. The forward estimates procedure was integrated with the annual budget cycle and constituted, in effect, a rolling planning system. Later, the forward estimates again excluded new programs and are now more fully integrated with the annual budget cycle. While the implications of forward estimates submitted by the departments to the Department of Finance form part of the context in which the broad fiscal strategy is determined, the three-year estimates as such are not seen as policy documents. Rather, they are internal documents viewed as an aid to decision making and do not constitute a multiyear expenditure commitment on the part of the Government.[1]

Aims and measures. Prolonged success in economic performance during the 1960s provided a favorable basis for the Labor Government that took office toward the end of 1972 to promote its social policy objectives. In conformity with its policy objectives, the Government set out to increase the share of resources taken up by the public sector and to change the distribution of income over a short period of time. Measures to this end included increased rates of pension, unemployment, and sickness benefits retroactive to December 1972; also, the budget for fiscal year 1973–74 contained major increases in expenditure for social services. Increases in old age and invalid pension rates were met by raising indirect taxes rather than social security contributions (which, as already noted, were absent in Australian taxation for most of the period). In 1975 a compulsory health insurance scheme was introduced for the first time.

Fiscal policy reaction to deepening recession and rising unemployment was to strengthen the already expansionary stance through reductions in income and company taxes. Employment-oriented advances to state and local governments were maintained at a high level, and special measures were taken to safeguard employment in the motor

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[1]James Cutt, "The Evolution of Expenditure Budgeting in Australia," *Public Budgeting and Finance*, Vol. 3 (Summer 1983), p. 18.

vehicle industry. The Government, faced with rising rates of inflation and a deteriorating external position, refrained from taking traditional demand management measures, which were seen as likely to cause still higher rates of unemployment. Instead, preference was expressed for action that directly attacked the wage-price spiral. The fiscal component of this strategy took the form of income tax reductions, introduced in late 1974, designed to reduce pressures for wage increases, which would, in turn, reduce inflation.

The upsurge in prices between 1972 and 1975 generated mounting concern about the detrimental impact on output and employment and on the external position. The new government that assumed office toward the end of 1975 regarded inflation and the sharply enlarged role and relative size of the public sector as major causes of depressed private sector activity and loss of business confidence. Revival of the private sector was seen as a precondition for sustained economic growth, but whether fiscal policy could stimulate employment amid the pessimism generated by pronounced inflation was doubted. The stage was thus set for a reversal of the previous expansionary stance of fiscal policy. Bringing inflation under control and reducing the rate of expansion of public sector absorption of resources were declared major aims of policy. In 1976, as part of the effort to slow inflation, indexation of the personal income tax was introduced. This measure had a dual purpose: moderating wage claims and thereby restoring profitability in the business sector, and containing the size of the public sector in the long run. Restrictive expenditure policy, however, was a more direct approach to containing the public sector and the Commonwealth Government followed it until almost the end of the period. Apart from general restraint in budget formulation and execution, special measures taken for this purpose included reductions in advances to state and local governments, staff ceilings for the civil service, direct expenditure cuts in specified areas, and the abolition in 1978 of the compulsory health insurance scheme (Medibank).[2]

Toward the end of the period, substantial slippages occurred in the restrictive stance, even if the consequences are only partially reflected in the statistics for 1982. Owing to increased expenditures to support employment and social security services, the share of total expenditure

[2]The operation of insurance schemes outside the public sector is encouraged through tax incentives for the insured.

in GDP started to rise in 1982 after five years of stability or decline. The deficit, while declining in 1982, has since widened sharply.

Overview and implications for future policy. The period covered thus witnessed a fundamental reversal in fiscal policy stance in Australia. From 1972 to 1975 the Government sought to reap the fruits of the successful economic performance in the 1960's by embarking on a course of expansion of social welfare services and an enlarged role for the public sector. The sharp increases in government expenditure resulting from this policy, together with expansionary development in other areas, led to growing imbalances in the economy. After a change of government at the end of 1975, policy was redirected to curtailing the role of the public sector and restoring overall economic balance. An important objective related to fiscal balance was to bring inflation under control, using tax policy as a significant factor of the strategy. The restrictive fiscal stance relied largely on expenditure restraint, and substantial success was achieved in containing the government sector. Actually, expressed as a ratio to GDP, the size of the commonwealth government sector was reduced by 2 percentage points between 1976 and 1982. In view of the experience in other countries in the group, the absence of compulsory social security schemes may have contributed significantly to this result. More recent developments, however, point to a renewed upsurge in expenditure growth, and a public health insurance scheme has been reintroduced.

Success in containing expenditure growth accompanied a reduction in the fiscal deficit between 1976 and 1982, although revenue increase was limited by, inter alia, tax concessions to stimulate private sector activity and to moderate wage demands. The reduced deficits at the central level were consistent with the Government's anti-inflation policy, which was seen as a precondition for achieving sustainable economic growth in the medium term and higher employment. It should be noted, however, that although the deficit was substantially reduced at the commonwealth government level in the 1980–82 period, the improvement was partly offset by the deteriorating financial position of the state and local sector.

The overall public sector deficit thus remains high and is cause for concern because of its inflationary impact, through both the monetary implications of deficit financing and the inflationary expectations it generates. As already indicated, only limited progress has been made in reducing inflation, which has remained one of Australia's main eco-

nomic problems, and the achievement of better balance in the public finances is likely to remain a major task of future policy. The effort needed is accentuated by recent slippages in the pursuit of fiscal policy toward this end.[3]

[3] As a result of successive expansionary budgets since 1983, the budget deficit has risen sharply. Deficits in the state and local sectors have also widened. While the rate of inflation has abated in recent years, it still remains high compared with the experience in main trading partner countries. These developments have accentuated the need for fiscal adjustment to support efforts to establish sustained noninflationary growth and reduce the high rate of unemployment.

2

Austria

The openness of the Austrian economy, in which foreign trade amounts to approximately one fourth of GDP, makes it vulnerable to external disturbances; consequently, a major aim of fiscal policy has been to smooth out economic fluctuations to secure full employment. Despite variances in growth rates from year to year, the economy had an impressive growth performance over the period 1972–82, about 3 percent a year on average, although the last two years witnessed unusual slack in economic activity. The great importance assigned to the maintenance of full employment resulted in lower unemployment rates than experienced in most other industrial countries. It was not until 1981 that unemployment rose appreciably above 2 percent, and in the following year it rose to 3½ percent.

Despite strong inflationary pressures caused by the oil price crises, average annual price increases were kept at about 6½ percent during the period, which is well below the average for industrial countries. A strong social consensus among labor market partners and the Government, the so-called social partnership, coupled with a hard currency exchange rate policy, were significant contributors to this achievement.

The external current account did not show large deficits in individual years, but they were persistent. In 1982, for the first time in a decade, the current external account turned into a surplus, equivalent to a little over 1 percent of GDP. Although caused in part by sharply higher oil prices, the current account deficits also reflected the impact of fiscal deficits that were experienced in every year during the period under review. The fiscal and external deficits have become a cause for growing

Austria: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	6.2	4.9	3.9	−0.4	4.6	4.4	0.5	4.7	3.0	−0.1	1.0
Rate of unemployment	1.2	1.1	1.4	1.7	1.8	1.6	2.1	2.1	1.9	2.5	3.5
Consumer prices, percentage changes	6.3	7.6	9.5	8.4	7.3	5.5	3.6	3.7	6.4	6.8	5.4
External current account balance as percentage of GDP	0.1	−0.3	−1.0	−0.1	−2.3	−3.6	−0.7	−1.0	−2.7	−2.0	1.1

Source: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984.

Austria: Consolidated Central Government Finances, 1972–82

(Year ended December 31)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue (as a percentage of GDP)	29.9	30.3	30.8	31.5	31.5	32.2	34.7	35.0	35.3	36.8	35.5
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	20.4	19.8	21.4	20.4	19.6	19.8	21.2	20.7	20.6	20.5	20.0
Social security contributions	29.9	30.4	30.9	32.7	33.0	33.7	35.1	34.8	35.2	35.0	35.4
Payroll (manpower) taxes	7.2	7.6	7.6	7.8	7.9	7.9	6.8	6.6	6.5	5.8	5.8
Property taxes	2.2	1.9	1.8	1.9	1.9	1.8	1.9	1.8	1.7	1.7	1.6
Taxes on goods and services	27.9	29.5	28.1	27.0	27.7	26.9	25.6	25.7	25.0	24.8	25.0
Taxes on international trade	5.3	4.7	4.2	3.2	2.7	2.3	1.5	1.5	1.5	1.4	1.3
Other taxes	0.6	0.4	0.4	0.4	0.5	1.2	0.8	0.8	0.8	1.0	1.1
Nontax revenue and grants	6.6	5.7	5.6	6.5	6.7	6.4	7.1	8.2	8.7	9.8	9.8
Total Expenditure (as a percentage of GDP)	30.1	31.9	32.3	35.5	36.1	35.9	38.8	38.7	38.6	39.7	39.9
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	30.4	25.8	26.2	27.1	27.1	27.0	26.0	25.8	25.6	25.7	25.9
Of which:											
Wages and salaries	14.6	10.8	10.6	11.0	11.2	11.0	10.6	10.4	10.3	10.3	10.2
Interest payments	2.1	1.9	1.9	2.2	3.1	3.6	4.1	4.3	4.6	4.9	5.6

Subsidies and other current transfers	55.7	56.2	58.0	58.6	58.6	59.6	60.0	59.7	59.1	58.7	58.9
Of which:											
Social security funds	...	25.1	25.6	26.5	27.1	27.4	26.3	26.5	26.8	26.7	26.2
Capital expenditure	9.8	13.7	10.6	10.6	9.1	8.3	7.7	8.0	8.5	8.9	8.1
Lending minus repayments	2.0	2.4	3.2	1.5	2.1	1.5	2.2	2.3	2.1	1.7	1.5
Surplus/Deficit (as a percentage of GDP)	−0.2	−1.6	−1.5	−4.0	−4.6	−3.7	−4.0	−3.7	−3.2	−2.9	−4.4
Financing:											
Abroad	−0.3	−0.1	0.8	2.8	0.5	1.7	1.4	0.6	0.9	1.6	1.4
Domestic	0.5	1.7	0.7	1.2	4.1	2.0	2.6	3.1	2.4	1.4	3.0
Monetary authorities	—	0.1	0.1	—	—	—	—	—	—	−0.1	—
Deposit money banks	0.1	—	—	0.3	0.7	0.4	0.4	0.8	0.1	0.5	0.9
Other[1]	0.4	1.7	0.7	0.9	3.4	1.7	2.2	2.3	2.4	0.9	2.1
Memorandum Items:											
General government expenditure and net lending/GDP	41.3	43.1	44.6	48.2	49.1	48.3	51.7	51.0	51.0	52.8	52.2
Central government debt outstanding/GDP	10.5	10.4	10.0	15.3	18.5	20.8	23.6	25.2	26.3	28.0	30.0

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.
[1] Includes adjustments.

concern as have certain structural problems partly related to the emphasis in fiscal policy on employment.

EXPENDITURE

From 1972 to 1982 the ratio of government expenditure to GDP rose from 30 percent to 40 percent. Expansionary fiscal policies designed to sustain activity and employment in the wake of the first oil price shock, as well as a fall in real GDP, largely explain the 3 percentage point rise in the share of government expenditure in 1975. Following two years at this level, the share rose by a further 3 percentage points in 1978, again the result of near-stagnant growth and measures to stimulate investment and secure employment. The ratio of government expenditure to GDP remained between 38½ percent and 40 percent until 1982. Expenditure on goods and services, including wages and salaries, shared in this relative increase, with its share in total expenditure remaining fairly constant at about 26 percent throughout most of the period. Subsidies and other current transfers increased faster than total expenditure, from 55½ percent to almost 59 percent of the total, reflecting increasing transfers to public and private enterprises and, in a lesser degree, social security funds. Interest payments on government debt took up a steadily growing share of total expenditure, from 2 percent in 1972 to 5½ percent in 1982, while the share of direct capital expenditure in the total declined from 10 percent to 8 percent. Net lending averaged about 2 percent of total expenditure with small deviations during the period.

REVENUE

Although the ratio of total revenue to GDP rose in most years from 1972 to 1982, it remained below that of expenditure throughout the period and rose less, from 30 percent to 35½ percent. Income taxes shared in this increase and remained around 20 percent of total revenue. The elasticity of this tax with respect to GDP was reduced by successive discretionary actions aimed at lessening the tax burden of low- and middle-income earners, stimulating business investment and employment, and reducing fiscal drag. Social security contributions paid by employers and employees grew faster than total revenue, with their share increasing from 30 percent to 35½ percent of total revenue during the period, reflecting, inter alia, higher rates.

Taxes on goods and services, of which the value-added tax (VAT) accounts for almost two thirds, declined as a percentage of total

revenue, or from 28 percent in 1972 to 25 percent in 1982. Despite increased rates, the VAT grew at about the same rate as GDP, while excises, the other main tax in this category, declined in relation to GDP, as many of these taxes are specific rather than ad valorem. The share of payroll taxes not earmarked for social security expenditure declined slightly from 7 percent to 8 percent in 1972–77 to 6 percent in 1982, while the share of property taxes remained roughly constant at slightly under 2 percent. Taxes on international trade have become less important as a result of the phased abolition of duties on imports from the European Communities (EC) during the period 1973–77. Nontax revenue, because of higher property income, increased in relative significance, and by the end of the period accounted for almost 10 percent of total revenue, compared with 6½ percent in 1972.

THE FISCAL BALANCE AND ITS FINANCING

In each year of the period the central government finances recorded deficits, which amounted to 4 percent of GDP in the recessionary year of 1975 and reached a peak of over 4½ percent of GDP in the following year. These deficits are indicative of a deliberate expansionary fiscal policy stance that was aimed at neutralizing the effect of the first oil price crisis on activity and employment. Since then, high fiscal deficits have caused growing concern, but efforts to reduce them have been hampered by the policy objective of maintaining a high level of employment through tax concessions and employment-supporting expenditures. From 1977 to 1982, the fiscal deficits ranged between 3 percent and 4½ percent of GDP.

The Austrian Postal Savings Bank makes recommendations for deficit financing. Recourse to the central bank is confined to short-term discounting of treasury bills up to 5 percent of the past published tax receipts of the central government. The financing requirement is met largely by long-term borrowing in the private domestic market or abroad, the share of external borrowing being determined with a view to the domestic liquidity situation. Except in 1975, when external financing covered 70 percent of the deficit, and in 1981 and 1982, when similar ratios were 55 percent and 68 percent, respectively, most of the financing requirement has been met by domestic sources. The persistent fiscal deficits entailed growing government debt which, expressed as a ratio to GDP, rose from 10½ percent to 30 percent between 1972 and 1982. Over the same period the share of foreign debt in total debt rose from 20 percent to 32 percent.

FISCAL POLICY

The framework. The Central Government accounts for about three fourths of total general government expenditure, which in 1982 was almost equivalent to 52 percent of GDP. This expenditure includes transfers to other levels of government that amount to approximately one third of their total revenue and grants. Local government budget deficits have been fairly constant over time (at less than 1 percent of GDP) and thus do not play an active role in countercyclical policy. In the early years of the period, however, when inflation was a major preoccupation of economic policy, local governments pursued a restrictive expenditure policy; they refrained from increasing various fees and charges, and their share in federal taxes was temporarily frozen as special deposits in the central bank. Outside the budget proper, the Central Government has relied on the national industries and, in recent years, on special government organizations to realize the fiscal objectives of sustaining a high level of employment and supporting the business sector, especially the export industry.

The budget of the Central Government is prepared on an annual basis; long-term budgeting is not practiced. Since 1972, the ordinary budget has been supplemented by a contingency budget that can be activated in case of unexpected weakening of demand. In an effort to make fiscal policy more flexible, special provisions were introduced in the 1976 budget law that allow for the contingency budget to be implemented without further parliamentary approval if certain conditions are met. Also, revenue shortfalls, up to 5 percent of the year's estimate, could be offset by borrowing without further authorization by Parliament. The contingency budget is made up of two tranches: a stabilization tranche that can be activated to alleviate problems in certain industries or regions, and a reflationary tranche that can be used to stimulate economic activity in general. The contingency budget was activated in the 1974–76 period and again in 1983.

Aims and measures. As indicated earlier, full employment was a major aim of fiscal policy throughout the period, although the emphasis naturally varied according to overall conditions in individual years. The Government's contribution to the social partnership consisted largely in commitments to secure a high level of employment. Against a background of unstable external conditions, the authorities have relied on the federal budget as their chief anticylical instrument through the exercise of a flexible fiscal policy.

Having pursued a strict fiscal policy in the first years of the period in response to growing inflationary pressures, the Government shifted its policy priorities toward sustaining employment in mid-1974 to counteract the impact of sharply higher oil prices. In the following two years, the vigorous pursuit of this new objective, through both sides of the budget, led to a sharp widening of the fiscal deficit. Among measures on the expenditure side were the activation of contingency budgets during the period 1974–76 for road construction and other public investments, as well as for subsidies to agriculture, mining, and exports, release of frozen funds of local governments, and subsidization of investment credit to the business sector. Revenue measures that aimed directly at the stimulation of employment and private sector activity included special depreciation allowances for certain types of investment and a suspension of the investment tax that had been imposed in 1973 to make up for revenue loss (repayment of taxes on inventories) caused by the adoption of a value-added tax in that year.

The expansionary fiscal policies caused considerable concern, not only because of the rising public debt, but also because of the structural character of the fiscal deficit that was gradually becoming evident, with adverse implications for the future flexibility of fiscal policy. The elasticity of the revenue system had declined owing to tax changes, especially in direct taxes, embodied in an income tax reform initiated in 1973 that was intended to reduce the tax burden of low- and middle-income earners. Company taxation was also reduced to stimulate investment. At the same time, certain expenditure categories expanded rapidly, especially subsidies to public enterprises. Transfers to the social security system also escalated, in particular for pension insurance, which, unlike the health and accident insurance, is not financed by private contributions, but by substantial transfers from the budget. The increase in pension expenditure also reflected a steady rise in the ratio of pension receivers to the work force that contributes. The sharply deteriorating current account position of the balance of payments in 1976 and 1977 was another cause for concern, as was the rising unemployment in the years following, which, at around 2 percent, represented historically high rates for Austria.

The policy response to these developments was a so-called "dual strategy," which tried to deal simultaneously with the fiscal and external deficits and the depressed state of economic activity. In the budget for 1978, the authorities announced their aim of reducing the fiscal deficit in the medium term; a target was set at about 2½ percent of GDP in that

year and in the following year at about 2 percent. To restrain domestic demand and reduce the fiscal deficit, various tax measures were introduced, such as an increase in the VAT rate from 16 percent to 18 percent in 1976 and a third VAT rate of 30 percent on luxury goods in 1978.[1] Subsequent revenue-raising measures have mainly included indirect taxes, such as energy taxes, but further income tax reductions have been continued, largely to compensate for fiscal drag.

Despite the increased emphasis on reducing fiscal and external deficits since 1977, preserving a high level of employment has continued to be a major aim of fiscal policy. To fulfill this part of the dual strategy, investment promotion programs were initiated in 1978 and employment programs were introduced in 1982. Apart from direct budgetary investment outlays, these programs have included interest rate subsidies and tax credits for certain types of investment. The nationalized sector has also played a significant role in the high employment policy by traditionally maintaining employment during recessions. However, this practice has added to the financial difficulties of the sector, which, in turn, have placed a further burden on future budgets, as the Government has in recent years assumed debt repayment obligations for the nationalized industries, in addition to paying direct subsidies. Private sector activity has also received similar support from the Treasury, which has assumed obligations relating to export guarantees as a means of promoting exports.

Overview and implications for future policy. A striking feature of fiscal policy over the past decade has been its success in maintaining full employment. The wider implications of this success, however, are less satisfactory. The declining growth performance of the economy toward the end of the period is in part attributable to insufficient structural adjustment, which was presumably delayed by the high employment policy that tended to slow down labor mobility. Policymakers now face a difficult choice between the social and economic aspects of policy. Also, the growing practice of supporting selected industries by granting credit guarantees and assuming debt-servicing payments has not only entailed a future budgetary burden but might also reduce incentives for efficiency and retard the adjustment process.

An additional implication of past fiscal policy stems from the persistence of fiscal deficits. It is arguable that the impact of increased fiscal deficits on interest rates may be limited, as interest rates in Austria

[1] These rates were raised further by 2 percentage points in 1983.

are determined by external rather than domestic factors. While such factors may in part explain why the deficits did not appear to be crowding out private investment, the depressed state of activity and the slack in private sector demand for credit in the last years of the period may be a better explanation for the absence of crowding out. However, there is a probability that protracted deficits could affect expectations and exert an upward pressure on interest rates, and economic recovery might soon create crowding-out problems. Also, failure to reduce the deficit would increasingly restrict the flexibility of fiscal policy, which has in the past contributed significantly to successful management of the economy.

The authorities reacted to the deteriorating fiscal position by announcing in 1978 their intention to reduce the fiscal deficit in the medium term and setting specific targets in that regard. After some initial success, these aims were negated by the working of automatic stabilizers and discretionary measures to support employment. Although economic recovery abroad would ease the task of improving the fiscal balance, a change in policy priorities with greater emphasis on expenditure restraint is nevertheless necessary. An important step in that direction could be the reform of the social security system, particularly the pension system, that the authorities are contemplating.

3

Belgium

Following several years of strong growth, real GDP declined by almost 2 percent in 1975; after a sharp recovery in 1976, when over 5 percent real growth was registered, economic activity again turned sluggish. The rate of unemployment rose from 3 percent in 1972 to over 13 percent in 1982. Inflation was also rising; after recording a relatively moderate rise in the latter half of the 1960s, consumer price increases reached a peak of almost 13 percent in both 1974 and 1975. Although the rate abated to a moderate 4½ percent in 1978 and 1979, reflecting in part stringent wage and price policies, it began rising again in 1980, and was close to 9 percent in 1982. The external current account position steadily deteriorated throughout the period—from a surplus equivalent to 3½ percent of GDP in 1972 to a deficit of 4½ percent in both 1980 and 1981. A combination of structural adjustment difficulties in the domestic economy, notably in the important steel industry, expansionary fiscal policies, and adverse external factors contributed to this development. The impact of external factors is particularly strong in the highly open Belgian economy, where foreign trade amounts to over 50 percent of GDP. However, as a result of broad-based measures in 1982 to reduce domestic and external imbalances, the current account deficit dropped to 3½ percent of GDP in that year. Large and persistent fiscal deficits were experienced over the period; their harmful impact on the external current account was substantially mitigated, however, especially in the early part of the period, by an unusually high ratio of private household savings that made noninflationary financing of the fiscal deficit possible.

EXPENDITURE

Probably the most striking feature of fiscal developments in Belgium during the period under review is the explosive growth of central

Belgium: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	5.3	6.2	4.5	−1.9	5.2	0.4	3.0	2.0	3.5	−1.3	1.1
Rate of unemployment	2.7	2.8	3.1	5.1	6.6	7.5	8.1	8.4	9.0	11.1	13.1
Consumer prices, percentage changes	5.5	7.0	12.7	12.8	9.2	7.1	4.5	4.5	6.6	7.6	8.7
External current account balance as percentage of GDP	3.6	2.0	0.4	−0.1	0.1	−1.3	−1.4	−2.7	−4.5	−4.5	−3.5

Source: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984.

Belgium: Consolidated Central Government Finances, 1972–82

(Year ended December 31)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue											
(as a percentage of GDP)	35.4	36.5	37.4	40.1	40.4	41.7	42.7	42.9	43.6	43.9	44.7
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	31.2	33.0	34.6	36.8	35.8	37.3	38.8	39.6	38.2	37.6	39.4
Social security contributions	32.2	32.1	31.8	32.3	32.2	31.5	30.6	30.6	30.4	30.7	29.9
Payroll (manpower) taxes	—	—	—	—	—	—	—	—	—	—	. . .
Property taxes	3.0	3.1	2.8	2.5	2.7	2.8	2.9	3.0	2.4	2.0	1.8
Taxes on goods and services	28.7	27.5	26.5	24.4	25.4	24.6	24.5	23.2	24.5	24.4	23.9
Taxes on international trade	1.0	0.5	0.4	—	—	—	—	—	—	—	. . .
Other taxes	0.3	0.3	0.3	0.3	0.1	0.1	0.1	0.1	0.2	0.1	0.1
Nontax revenue and grants	3.6	3.6	3.7	3.7	3.8	3.7	3.2	3.6	4.4	5.3	5.0
Total Expenditure											
(as a percentage of GDP)	39.8	39.9	39.6	44.8	46.0	47.7	49.5	50.5	51.3	56.2	56.9
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	24.9	24.6	24.8	24.7	24.0	23.4	23.2	22.6	22.2	21.4	20.5
Of which:											
Wages and salaries	17.6	17.7	18.0	17.5	17.2	16.8	16.3	15.9	15.7	15.2	14.7
Interest payments	6.6	6.6	6.9	6.1	6.2	6.7	7.2	8.1	9.8	11.9	13.5

Subsidies and other current transfers	56.0	58.0	57.9	59.9	60.1	60.5	59.7	60.1	57.7	56.7	55.6
Of which:											
Social security funds	33.3	34.2	35.3	37.2	38.3	38.2	37.7	38.3	37.5	36.8	36.5
Capital expenditure	12.0	10.2	9.4	8.3	8.5	8.5	8.1	8.0	8.3	8.6	8.8
Lending minus repayments	0.6	0.7	1.0	1.1	1.1	0.9	1.8	1.2	1.9	1.4	1.6
Surplus/Deficit (as a percentage of GDP)	−4.3	−3.5	−2.2	−4.7	−5.6	−5.9	−6.9	−7.6	−7.7	−12.3	−12.2
Financing:											
Abroad	−1.0	−0.2	−0.1	—	—	—	0.4	1.3	2.4	5.9	5.3
Domestic	5.3	3.7	2.3	4.7	5.6	5.9	6.4	6.3	5.3	6.4	6.9
Monetary authorities	−0.2	0.1	0.1	—	0.6	0.6	—	—	—	—	—
Deposit money banks	—	—	—	—	—	—	—	—	—	—	—
Other[1]	5.5	3.5	2.2	4.7	5.0	5.4	6.4	6.3	5.3	6.4	6.9
Memorandum Items:											
General government expenditure and net lending/GDP	...	...	...	...	...	...	53.6	55.3	54.6	61.5	61.9
Central government debt outstanding/GDP	45.0	42.5	39.0	40.0	40.3	43.2	46.2	49.7	54.8	65.2	73.9

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.
[1] Includes adjustments.

government expenditure; its ratio to GDP expanded by 17 percentage points, from 40 percent in 1972 to 57 percent in 1982. This increase was concentrated in two particular years, namely, 1975, when expansionary fiscal policy coincided with a decline in real GDP and the share recorded an upward shift of over 5 percentage points; and again in 1981, when similar events contributed to an almost 5 percentage-point rise in this ratio. Well over half the total relative increase thus occurred in these two years.

The major part of the expansion was accounted for by subsidies and other current transfers, especially to social security funds. This category roughly maintained its share in total expenditure at 56 percent over the period. Apart from deliberate policy action to improve real benefits, the growth of social security expenditures is also the result of demographic factors reflecting the aging structure of the population. Furthermore, depressed economic activity has triggered built-in fiscal stabilizers and caused an especially rapid growth of unemployment compensations. This last factor, in addition to generating increased outlays on direct unemployment benefits, has resulted in declining social security contributions from both employers and employees, thus necessitating increased central government grants.

Interest payments on government debt were the second most dynamic element underlying the expansion of the government sector. Their share in total expenditure rose from 6½ percent to 13½ percent over the period as a result of high and rapidly widening fiscal deficits and rising interest rates. While the share of expenditure on goods and services in total expenditure declined, it more than kept pace with GDP growth. Over 70 percent of this category is accounted for by wages and salaries, the growth of which is due, in part, to rising public employment brought about by the Government's unemployment relief policy. Similarly, while the share of capital expenditure in total government expenditure declined somewhat over the period, it grew in line with GDP. Net lending averaged just over 1 percent of total expenditure over the period.

REVENUE

From 1972 to 1982 the ratio of central government revenue to GDP rose by 9½ percentage points to 44½ percent in 1982, among the highest such ratio of the countries in the group. However, in the years preceding the period covered, the tax burden was lower than in many other industrial countries. The high elasticity of the tax system with

respect to GDP stems largely from progressive income taxes, which for most of the period were only partially adjusted for inflation. Social security contributions also rose faster than national income. Together, these two sources of revenue accounted for 69½ percent of total revenue in 1982, their share having risen from 63½ percent in 1972. A regime of value-added taxes was introduced in 1971 and accounts for about two thirds of taxes on goods and services, which declined as a proportion of total revenue from almost 29 percent in 1972 to 24 percent in 1982. However, the ratio of this type of tax to GDP has remained almost constant. Other taxes taken together became less significant revenue sources over the period, while nontax revenue increased its share in the total from 3½ percent to 5 percent.

THE FISCAL BALANCE AND ITS FINANCING

In the years 1972–74, revenue increased faster than expenditure and the fiscal deficit declined. Since 1974 the respective growth rates were reversed, with the deficit steadily widening as a proportion of GDP, or from 2 percent in 1974 to 12 percent in 1982. The high private savings ratio that had formerly mitigated the monetary impact of the large and growing deficits became less effective, not only because the deficits were growing, but also because the households' savings ratio was declining—from 17.3 percent on average in 1972–76 to 15.9 percent during 1977–80. These contrary movements entailed a change in the pattern of deficit financing. Until 1978 the deficit had been financed entirely by domestic sources, mostly in the form of bond sales in the capital market. In that year, for the first time in a decade, the authorities turned to foreign borrowing despite their stated reluctance. Since then, an increasing portion of the deficit has been financed abroad—almost one half in 1982—with only slight recourse to domestic monetary financing, and none since 1977. As a consequence of the mounting fiscal deficits, government debt rose sharply over the period—from 45 percent of GDP in 1972 to 74 percent in 1982. This ratio has since risen further and is one of the highest among industrial countries.

FISCAL POLICY

The framework. In 1982 the ratio of general government expenditure to GDP was almost 62 percent. Including transfers to local governments, over 90 percent of total public sector spending was accounted for by the Central Government. Despite the limited size of local governments, their fast growing expenditure resulted in deficits whose financing

requirement amounted to 10 percent to 15 percent of the public sector borrowing requirement (PSBR) in the 1980–82 period. In light of this rise, the Government decided toward the end of 1982 to avail itself of special powers and adopted a decree that imposed balanced budgets on the local authorities from 1988. Consequently, local governments were granted greater revenue-raising possibilities by the abolition of the previous limit on the local surtax on personal income tax.

The broad lines of the Government's economic policy are set forth in an overall plan, the National Plan, which covers five-year periods. According to the provisions of a law enacted in 1970, the plan is to be reflected annually in the budget. In practice, coordination of the budget and the plan pertains especially to public investment, while the plan in general is regarded as indicative. The plan, which is debated and passed by Parliament, sets targets for public investment that may be adjusted over the course of the period in line with short-term policy aims without upsetting the aggregate target.

The Belgian budget is made up of two main accounts: the ordinary budget, containing mainly current expenditure and revenue as well as amortization of debt; and the extraordinary budget, which includes investment expenditure. In the early 1970s, and for several preceding years, the ordinary budget remained in approximate balance; investment expenditure in the extraordinary budget was relied on to provide flexibility in fiscal policy. The flexibility initially derived from a certain part of the Government's investment program—the so-called *tranche conditionelle*—which was set aside to be used only when cyclical conditions in the economy warranted; the size of the investment program itself was determined with regard to the economic outlook. Later, the *tranche conditionelle* was replaced by a supplementary program in addition to the base program for capital expenditures. This innovation, while closely resembling the previous technique, was intended to increase flexibility in adapting expenditure levels to changes in the economic outlook. The supplementary program was first introduced in the 1975 budget and accounted for 0.4 percent of GDP. Widening fiscal deficits have severely restricted the scope for applying these techniques effectively, and vastly increased transfer payments have in particular pre-empted any large-scale use of capital expenditure to stimulate activity and employment. Fiscal multipliers are relatively small in the highly open Belgian economy, and especially so in the case of transfers.

Aims and measures. Until the mid-1970s fiscal policy was largely concerned with inflation. The main emphasis was placed on curbing

capital expenditures, but the pursuit of a restrictive expenditure policy was hampered by previous and ongoing commitments in social security programs. Inflation itself was also found to be an obstacle to expenditure restraint, not only on account of salary indexation and transfers, but also because the responsive tax system made it easier to finance new expenditures. Changes of government further weakened effective resistance to pressures for increased public spending. By mid-1975, the prospects for employment and output had severely worsened and policy priorities changed; unemployment became the major concern. Special measures were announced to stimulate the economy and to prevent a further increase in unemployment without adding to inflationary pressures.

In subsequent years, fiscal policy became defensive, seeking to mitigate the impact of the depressed state of economic activity experienced in the remainder of the period. Automatic fiscal stabilizers triggered ever-increasing social security outlays and reduced revenue growth. Discretionary measures included several programs to stimulate employment in the private sector, including providing credit to finance additional hiring to firms that had agreed to cut working hours. Ailing industries also received extensive support. To counteract rising unemployment, public sector employment was increased and early retirement schemes were introduced.

The most dynamic force underlying expenditure growth, however, is the social security system. In addition to demographic and cyclical factors, the system's rising cost is the result of indexation of benefits to wages or prices and the policy, pursued by successive governments, of improving benefits in real terms and expanding their coverage. The system is quite extensive, and the various schemes are administered by separate commissions—an arrangement that tends to complicate consistent decision making and weakens effective control over expenditure. The result is that social benefits, notably unemployment compensations, have become more generous in Belgium than in most other countries. It is estimated that over 80 percent of Belgian households receive support from the system in one form or another, and that one fourth of all households are entirely dependent on it financially. In response to the deterioration in the financial position of the social security system, the authorities have taken measures to limit the increase in benefits. A comprehensive review of fundamental aspects of the system is under consideration, with the goals of improving efficiency in income redistribution and work effort and eliminating deficiencies in other areas. A

change in the method of financing the system is also under consideration: employers' contributions would be based on the value added by firms rather than on the number of employees or the wage bill. This method would not distort the relative cost of labor as the present system does.

For most of the period, fiscal policy has relied on expenditure rather than tax measures. The observed significant increase in direct taxes was mostly generated automatically by the progressivity of the income tax system. Only toward the end of the period was a more active tax policy applied: certain investment incentives were introduced in 1979, and full indexing of income tax scales for lower income groups, in 1980. Moreover, in 1981 part of employers' social security contributions, which had become a heavy burden in the depressed economic conditions, was substituted by an increase in value-added and excise taxes. These measures were taken to some extent in the context of incomes policy, but with the exception of a temporary wage freeze, government intervention in income formation has been limited.

A special feature of fiscal policy in Belgium in the early 1970s was the conduct of large-scale open market operations in support of monetary policy. By borrowing domestically in excess of the financing requirement, this debt management policy aimed at sterilizing the liquidity impact of inflows of foreign funds and reducing foreign debt. Also, short-term domestic debt was converted through the sale of long-term bonds in the domestic market. As indicated earlier, fiscal policy subsequently played a reverse role in this respect.

Overview and implications for future policy. For most of the period, fiscal policy in Belgium was conducted against an unfavorable economic background. Also, the political environment was less than conducive to the formulation of consistent long-term policies. The high priority assigned to various social policies contributed to the continued growth in fiscal deficits in the wake of the 1974–75 recession, unlike in most countries in the group where the deficits tended to stabilize or decline. The large and growing deficits implied a sharp rise in the central government debt, which, as a percent of GDP, had become among the highest in industrial countries. A falling private savings ratio entailed increasing monetary financing of the deficits. Nonmonetary deficit financing, mostly by the sale of bonds, exerted upward pressure on long-term interest rates, which remained relatively high in Belgium. The high interest rates were detrimental to the economically depressed private sector, which was also burdened by rapidly growing direct taxes.

Concern has been growing over these and other implications of past fiscal policies, such as the constrictive impact of employment-stimulating measures on structural adjustment and the erosion of work incentives by generous unemployment benefits. Despite delays caused by political controversies, the authorities have in recent years been able to make some headway in implementing a financial reform of the social security system. Moreover, specific medium-term fiscal targets were announced in the 1982 budget which aimed at reducing the total public sector deficit from 14½ percent in 1981 to 7 percent in 1985, largely through expenditure restraint. A slower than expected recovery of domestic and external demand and other subsequent developments, however, obliged the authorities to revise their timetable for reducing the deficit. The task of establishing a fiscal balance that would be consistent with medium-term investment and savings volumes in other sectors of the economy and a sustainable balance on external current account is therefore likely to remain a major preoccupation of fiscal policy for a number of years. The mounting debt-servicing burden will require an especially determined effort, even if external conditions were to improve appreciably.

4

Denmark

The relatively open Danish economy, where foreign trade amounts to 25 to 30 percent of GDP, was severely affected by the two oil crises and the ensuing global recession. Denmark's heavy dependence on imported energy made it especially vulnerable; in 1973 oil imports accounted for 90 percent of its basic energy supplies.

A sudden drop in GDP growth occurred in 1974 and 1975, when GDP actually fell by about 1 percent in each year. Growth rebounded to 6½ percent in 1976, in response to a sharply expansionary policy, but in subsequent years it was sluggish and uneven. The poor growth performance during the past several years reflects not only the effect of external impulses, but also restrictive economic policies that were imposed to alleviate the persistent balance of payments problem.

Unemployment rose drastically over the period, with the rate of registered unemployed rising from less than 1 percent in 1973 to 10 percent in 1982. Although the slowdown of economic growth may have accounted for much of the rise in unemployment, increasingly generous unemployment compensations may also have contributed by undermining work incentives.

Inflation averaged more than 10 percent a year over the period, which is above the average for industrial countries. It reached high points in 1974 and 1980, 15½ percent and 12½ percent, respectively, owing largely to the oil price increases and accommodating financial policies, but the high rates have been sustained by the reliance on higher indirect taxation to curb private demand and by wage indexation mechanisms.

The external current account position was in deficit throughout the period. The deficit widened from 0.4 percent to over 3 percent of GDP between 1972 and 1974, but was halved in the following year when the

Denmark: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	5.4	3.8	−0.7	−1.0	6.5	2.3	1.8	3.7	−0.4	−0.9	3.4
Rate of unemployment	1.4	0.9	2.1	5.1	5.3	6.4	7.3	6.1	7.0	9.2	10.0
Consumer prices, percentage changes	6.6	9.3	15.3	9.6	9.0	11.1	10.0	9.6	12.3	11.7	10.1
External current account balance as a percentage of GDP	−0.4	−1.7	−3.1	−1.5	−4.9	−4.0	−2.7	−4.7	−3.7	−3.0	−4.1

Sources: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984; for unemployment data: Danmarks Statistik, Statistisk Tiårsoversigt 1983.

Denmark: Consolidated Central Government Finances, 1972–82

(Year beginning April 1st through 1975, and Year ended December 31 after 1975)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue											
(as a percentage of GDP)	34.6	34.5	35.0	33.0	34.9	34.7	36.7	37.4	37.8	37.5	36.9
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	39.3	41.6	45.4	40.6	37.2	35.2	34.6	33.4	33.5	33.7	33.8
Social security contributions	5.0	1.6	1.6	1.7	1.6	1.7	1.6	1.8	2.2	2.6	3.4
Payroll (manpower) taxes	—	—	—	—	—	—	—	—	—	—	—
Property taxes	2.7	3.3	2.4	2.3	2.3	3.2	3.3	3.2	3.0	2.6	2.2
Taxes on goods and services	41.4	41.5	38.2	40.0	41.1	44.2	44.3	45.4	44.2	44.3	43.6
Taxes on international trade	3.0	1.4	1.2	1.3	1.3	1.2	0.8	0.8	0.8	0.7	0.7
Other taxes	—	—	—	—	—	—	—	—	—	—	—
Nontax revenue and grants	8.3	10.4	11.2	14.0	16.5	14.6	15.5	15.6	16.3	16.1	16.3
Total Expenditure											
(as a percentage of GDP)	32.0	31.0	34.4	35.0	35.2	36.0	37.0	38.1	40.6	43.7	45.2
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	32.5	28.8	28.1	28.1	25.7	24.4	23.3	22.2	21.3	20.7	20.0
Of which:											
Wages and salaries	19.4	19.2	18.6	18.8	17.1	16.3	15.4	14.8	13.4	12.9	12.4
Interest payments	1.3	1.5	1.4	1.5	1.9	3.1	3.4	6.1	6.6	8.6	10.1

Subsidies and other current transfers	58.3	62.2	63.1	62.9	64.2	66.3	67.3	66.7	66.7	64.9	64.0
Of which:											
Social security funds	4.3	1.6	4.3	6.7	6.6	7.9	8.9	9.2	10.3	11.9	11.8
Capital expenditure	6.5	6.1	5.8	6.3	6.9	5.3	4.8	4.4	4.2	4.5	4.7
Lending minus repayments	1.4	1.5	1.5	1.3	1.2	1.0	1.2	0.7	1.1	1.2	1.2
Surplus/Deficit (as a percentage of GDP)	2.6	3.5	0.7	−1.9	−0.4	−1.3	−0.3	−0.7	−2.7	−6.2	−8.3
Memorandum Items:											
General government expenditure and net lending/GDP	...	...	...	...	...	50.3	52.2	53.8	56.6	59.8	...
Central government debt outstanding/GDP	−1.6	−3.6	−1.7	4.5	8.4	13.2	18.2	24.7	33.7	45.9	59.2

Sources: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984; for government debt data: national sources.

domestic recession deepened and a marked fall in imports resulted. With subsequent temporary stimulus measures, the external position deteriorated sharply in 1976 when the current deficit reached 5 percent of GDP. In the remainder of the period, the current account deficit ranged between 3 percent and 5 percent of GDP. The persistent balance of payments problem has been a constant cause for concern to the authorities and has significantly shaped economic policy during the period under review.

EXPENDITURE

Between 1972 and 1982 central government expenditure rose as a percentage of GDP from 32 percent to 45 percent, which represents a continuation of the rapid expansion of the government sector that began in the 1960s. Expenditure on goods and services declined sharply as a proportion of total expenditure from 32½ percent to 20 percent, and within this category the share of wages and salaries in the total declined steadily from 19½ percent to 12½ percent. Measures to alleviate the unemployment problem by increasing public employment mostly affected the local government sector. Both wages and salaries and other expenditure on goods and services grew more slowly than GDP. By contrast, subsidies and other current transfers increased their share in the total from 58½ percent to 64 percent between 1972 and 1982, owing in part to increased unemployment compensations and measures to reduce costs and improve the competitiveness of enterprises.

With widening fiscal deficits in the period following the first oil crisis, interest payments on the government debt rose from 1½ percent of total expenditure in 1972 to 10 percent in 1982; there are signs that debt servicing will impose a sharply increasing burden on the budget in future years. Capital expenditure declined as a proportion of total expenditure from 6½ percent to 4½ percent between 1972 and 1982 and was a reflection of the increased reliance on cuts in investment expenditure as part of efforts to curb overall expenditure growth in the latter half of the period. Net lending has not been significant at the central level and ranged between 1 percent and 1½ percent of total expenditure over the period.

REVENUE

Central government revenue expressed as a ratio to GDP increased moderately from 34½ percent in 1972 to 37 percent in 1982 after having dropped to 33 percent in 1975. The share of income taxes, over 90 per-

cent of which are personal income taxes, in total revenue rose from 39½ percent in 1972 to 45½ percent in 1974 due in part to a pay-as-you-earn (PAYE) system of income tax collection that had been introduced in 1970. The share has since dropped sharply and was less than 34 percent in 1982. The drop reflects the depressed state of economic activity and a series of tax concessions designed to stimulate private sector demand and support incomes policy.

Taxes on goods and services, on the other hand, rose as a share of total revenue from 41½ percent in 1972 to 43½ percent in 1982. Increases in indirect taxes were the major fiscal instrument used to curb private sector demand—mainly through increases in the value-added tax, which was introduced in 1967 and in 1982 accounted for 60 percent of revenue in this category. A temporary reduction in the value-added tax partly explains the drop in the ratio of total revenue to GDP in 1975–77. Other taxes in this category include various excises and motor vehicle taxes, some of which are specific and have not kept pace with nominal GDP growth. Other tax revenue taken together, that is, social security contributions, property taxes, and taxes on international trade, declined as a share in total revenue from 10½ percent in 1972 to 6½ percent in 1982, reflecting in part the elimination of customs duties on products from EC member countries during a transitional period that ended at the beginning of 1978. Nontax revenue and grants, on the other hand, increased their share in the total from 8½ percent to 16½ percent over the period. The most important revenue items in this category are property income, administrative fees and charges, and grants from the EC.

THE FISCAL BALANCE AND ITS FINANCING

In most years from 1960 to 1974, central government finances were in surplus. But in the mid-1970s, automatic expenditure increases and revenue shortfalls brought about by recessionary conditions led to a sharp fiscal deterioration. In 1975 a number of discretionary measures were introduced to counteract the effects of the recession, and the fiscal position shifted to a deficit amounting to 2 percent of GDP. In the following four years the deficit contracted to about or less than 1 percent—owing to fiscal restraint in view of the worsening balance of payments position and high inflation rates. However, in 1979 it widened sharply and in 1982 reached the equivalent of more than 8 percent of GDP. The renewed upsurge in oil prices, a mounting debt-servicing burden, and expansionary measures taken in 1981 were largely respon-

sible for the widening deficit. No data on deficit financing are given in *Government Finance Statistics* (*GFS*), the basic source. There is evidence, however, that the deficit has been financed mostly by domestic sources and the external current account deficits have been financed mainly by external borrowing by the Government. The domestic financing requirement has been met by bond issues and the sale of securities to both the banking and nonbanking sectors; the latter have in recent years covered about three fifths of the gross borrowing requirement. At times, recourse has been made to the central bank. While these debt data should be interpreted cautiously, as government borrowing is also for balance of payments purposes, International Monetary Fund staff estimates indicate that total net central government debt, expressed as a proportion of GDP, rose from minus 1½ percent to 59 percent between 1972 and 1982.

FISCAL POLICY

The framework. The size of the local government sector is relatively larger in Denmark than in all the other countries in the group except Sweden and Norway. Of the almost 60 percent general government expenditure/GDP ratio in 1981, central government expenditure inclusive of transfers to other levels of government accounted for 44 percent. Although local governments derive approximately one half of their total revenue as transfers from the Central Government, their financial autonomy is substantial, as local councils have the right to determine the level of local income and property tax rates. As a result of a local government reform in 1970, responsibility for certain current and capital functions was transferred to the local level, while the Central Government took over a number of social security-oriented transfers.

Because of the significance of local government activity in the economy, fiscal policy issues have had to be coordinated at both levels, and a procedural framework has been developed which places emphasis on improving control over public expenditure in the medium term. Since the mid-1960s, multiyear budgeting has been gradually introduced into the budgetary process, and rolling budgets covering a three-year period beyond the next fiscal year are prepared annually and presented to Parliament with the annual central government budget.[1] Later, multiyear budgeting was adopted at the local level, and the first public sector budget was published in 1979. Although the public sector budgets

[1] *The Danish Budgetary System*, pp. 4–5.

are not formally binding on the Government, they form a basis for the establishment of overall ceilings on expenditure. Negotiations take place between the Central Government and the association of local governments about overall ceilings on real expenditure growth. The outcome of the negotiations takes the form of recommendations from the Central Government.

While the multiyear public sector budget has a sound technical and informational basis, the effectiveness of the system of centrally fixed ceilings is limited, as it relates only to expenditure that is not fixed by specific legislation. Major expenditure categories, chiefly transfers to persons and to local governments, are based on law, and, at the central level, account for some 60 percent of total expenditure. This proportion has been growing over the period. Another factor that tends to complicate long-term public decision making and to upset a steady policy course is Denmark's political system, which is characterized by coalitions or minority governments.

Aims and measures. Over the period, the persistent balance of payments problem had significant implications for the pursuit of fiscal policy. While external adjustment efforts relied on incomes policy and, toward the end of the period, on exchange rate adjustments, fiscal policy sought to contribute through restraining private sector demand, supporting incomes policy, and providing incentives for the transfer of resources to the export sector. Other major objectives of fiscal policy were to cushion the impact of the international recession on employment and activity and to improve social security benefits in real terms. Stabilization also became the province of fiscal policy, as monetary policy was mainly preoccupied with preserving the foreign reserve position, which entailed high interest rates to induce the capital inflows needed to finance the external deficit.

After general restraint in the early years of the period—achieved largely through a ban on new public investment projects—fiscal policy shifted in a highly expansionary direction in the wake of the first oil crisis; a number of discretionary measures to stimulate the economy were introduced in 1975. This action was prompted by rising unemployment and an easing of the balance of payments position. The improvement in the external balance proved to be short-lived, however, and with a sharply widening current external deficit in the following year, fiscal policy resumed a restrictive stance. In subsequent years, with a persistently high external deficit, fiscal restraint focused largely on increases in indirect taxes. The effectiveness of this approach,

however, was severely limited by measures on the expenditure side to contain rising unemployment and by tax concessions to stimulate demand. Fiscal restraint was further stymied by actions taken as part of incomes policy to curb inflation and to support the balance of payments adjustment process, as well as other actions, at times associated with changes of government, to improve social security benefits.

The resulting deterioration in the budgetary position was aggravated by cyclical factors that automatically caused social security payments to increase and revenue growth to slow down. Also, the inflationary conditions further weakened the fiscal position. Experience suggests that expenditure was more affected by inflation than was revenue, owing to indexation of significant expenditure components, the existence of specific excise and other taxes, and indexation of tax scales and deductions.

In contrast to the policy response to the first oil crisis, the fiscal stance remained tight in the first year after the second oil shock as far as discretionary action is concerned. However, as a result of the working of automatic stabilizers and a shift of fiscal policy in an expansionary direction in 1981, the fiscal position deteriorated markedly after 1978. With a new government in 1982, fiscal policy again assumed a restrictive stance.

The pursuit of fiscal policy toward the several goals discussed above involved a variety of measures. Measures on the expenditure side to stimulate demand and employment introduced before and during the mid-1970s included public building programs, subsidization of interest costs on loans for residential construction, and relaxation of ceilings on local government investment. Among measures to support employment in these and subsequent years was a program to increase public sector employment, financed partly by the Central Government, for retraining the long-term unemployed in the local government and private sectors. Youth employment programs were also introduced. Other measures have included subsidies for energy-conserving investment in the enterprise sector and for energy-saving repair and maintenance work in residential housing. The export industry has received grants and subsidies, as well as tax concessions.

In the social security field, in addition to full indexation of pensions, benefits have been raised in real terms and their coverage extended. In 1979 an early retirement scheme was introduced to encourage wage earners in the 60–66 age group to withdraw from the labor force. A generous system of unemployment compensations has been developed

to serve the high-priority social objective of relieving distress. A rapidly growing labor force in recent years, owing mainly to a rising female participation rate, has constituted growing claims on budgetary resources.

Stimulatory measures on the revenue side included a substantial reduction in the personal income tax at the beginning of 1975. This reduction followed intense controversy over the prevailing high marginal tax rates—on average, one half of each increment to money wages was being absorbed by direct taxes—which were thought to have significantly contributed to the speed of cost-inflation. The issue had important political implications; a new party placing the abolition of income tax at the top of its platform won 15 percent of the seats in Parliament in the 1973 general elections. The income tax reduction was at the same time intended to moderate wage settlements, and similarly motivated cuts were made in subsequent years. The personal income tax scales have been indexed since 1970. One stimulatory measure taken in 1975 was a reduction in the value-added tax from 15 percent to 9¼ percent, which was maintained until 1977. Company tax reductions have taken the form of increased depreciation allowances, such as a countercyclical special depreciation allowance on investment in plant and machinery. Toward the end of the period, depreciation allowances were indexed. Measures specifically designed to support incomes policy and to contribute to the balance of payments adjustment process include the already cited cuts in the personal income tax and payment by the central government of a portion of indexation compensations due to workers into blocked individual accounts with the Supplementary Labor Market Pension Fund.

As already mentioned, the restrictive stance of fiscal policy relied on increases in indirect taxation, especially the value-added tax, which after the temporary reduction during 1975–77, was raised in stages from 9¼ percent in 1977 to 22 percent in 1980. Taxes on energy use were also raised largely for conservation, and a number of specific excise duties were increased, although these hardly kept pace with GDP growth, as indicated earlier. Rapidly expanding public sector activity has long been a cause for concern to the Danish authorities, and restraint on the expenditure side has been part of the fiscal strategy since 1976. Successive governments set targets to contain public expenditure growth, but successful realization of these targets has been limited, especially at the central level. Although local governments assumed a fair amount of the burden of containing unemployment through

employment-creating schemes, their expenditure has grown less than central government expenditure over the past several years, mainly because the Central Government, in connection with the local government reform in 1970, assumed responsibility for the rapidly growing social security expenditures.

Overview and implications for future policy. Owing to the openness of the economy and in particular its high dependence on imported energy sources, the impact of the two oil crises and recessionary external developments was especially strong in Denmark. These events exacerbated the country's longstanding balance of payments problem and posed a difficult dilemma for fiscal policy, which was a major instrument of stabilization throughout the period under review. Attaining the objectives of cushioning the impact of recessionary trends and improving social security benefits in real terms without imparting undue pressure on the balance of payments has proved elusive and has been complicated by changes in policy priorities.

Official goals to contain public sector spending have not materialized, despite long-term planning that was intended to enhance public awareness of the consequences of continuing past trends for private sector activity and overall performance of the economy. Instead, the period witnessed an explosive growth of central government expenditure whose ratio to GDP expanded from 32 percent to 45 percent from 1972 to 1982, with the public expenditure/GDP ratio reaching almost 60 percent by 1981, implying a sharply widening fiscal deficit and a heavy accumulation of government debt.

The major contributor to this deterioration in the fiscal position is the generous social security system whose foundations were largely laid in more prosperous times when prospects for the economy were brighter. Unemployment benefits have been the fastest-growing element, and although they may have relieved distress, they may at the same time have generated disincentives to work. The long-term consequences of high social security expenditure are likely to inhibit the growth of the economy and employment; adjustment to the real growth prospects would seem a prime objective of future fiscal policy.

Reversing these trends was indeed a major objective of one new government. In 1982 it introduced measures to substantially reduce automaticity in expenditure determination by suspending wage and salary indexation and the indexation of certain transfers until 1985, and by limiting increases in public sector wage and salary rates during the same period. While these measures soon led to improvements in certain

areas, serious external and internal imbalances remained. Despite prospects for domestic energy production and more favorable external conditions, past experience strongly suggests the need for a resolute course of fiscal policy over an extended period with a clear order of priorities, if lasting improvements are to be achieved. The effort needed is all the greater because of increasing rigidities in the fiscal system owing to indexation mechanisms, a tendency to fix expenditures by specific legislation, and a growing future debt burden.[2]

[2] A substantial fiscal adjustment has taken place since 1982 owing to both revenue-raising measures and expenditure restraint. Discretionary actions include the introduction of a tax on pension funds, raising of user charges, containment of certain social security transfers in nominal terms, and a reduction in transfers to local governments. The impact of the temporary suspension of indexation mechanisms is also significant in this respect. Government expenditure other than interest payments declined as a proportion of GDP by several percentage points between 1982 and 1984. The Government has announced its intention to reduce the budget deficit annually until a balance is established by the end of this decade.

5

Finland

A large external sector with imports and exports amounting to almost 30 percent of GDP makes the Finnish economy vulnerable to external influences; this vulnerability is accentuated by the country's reliance for exports on raw materials and semimanufactures, which are subject to sharp swings in demand. Such influences explain in large measure the fluctuations in economic growth over the period.

After real GDP had increased by 7½ percent and 6½ percent in 1972 and 1973, respectively, growth rates declined sharply during the world recession in 1974 and remained at 0.6 percent or less in each of the following three years. With international recovery, GDP growth picked up in 1978 and reached the pre-1974 rates in 1979 and 1980, after which a renewed stagnation set in. The rate of unemployment was kept below 2½ percent up to 1976 but increased in that and the following years, reaching a high of over 7 percent in 1978. Since 1980, however, unemployment has, at 5 percent to 6 percent, been below the average for industrial countries. The rate of inflation accelerated from 7 percent to 18 percent between 1972 and 1975 and remained high during the next two years. A stabilization program in 1977 succeeded in bringing the rise in consumer prices to between 7 percent and 8 percent in 1978 and 1979, but subsequently, inflation accelerated again. In most years from 1972 to 1982, the current external balance was in deficit. The largest deficits, ranging from 4 percent to 8 percent of GDP, were recorded in the 1974–76 period, but they have since declined substantially. The fiscal position changed from annual surpluses in the early years of the period to deficits since the mid-1970s, reflecting, inter alia, the promotion of social services, a more intensive application of fiscal policy in support of the economy, and measures to contain the tax burden.

Finland: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	7.5	6.5	3.2	0.6	0.3	0.4	2.3	7.6	6.0	1.5	2.5
Rate of unemployment	2.5	2.3	1.7	2.2	3.8	5.8	7.2	5.9	4.6	5.1	5.8
Consumer prices, percentage changes	7.1	10.7	16.9	17.9	14.4	12.2	7.8	7.5	11.6	12.0	9.6
External current account balance as percentage of GDP	−1.0	−2.1	−5.3	−7.8	−3.9	−0.5	1.9	−0.4	−2.7	−0.6	−2.0

Source: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984.

Finland: Consolidated Central Government Finances, 1972–82

(Year ended December 31)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue											
(as a percentage of GDP)	26.7	27.3	26.3	27.9	31.0	30.5	28.6	27.4	27.5	28.6	28.6
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	29.4	30.9	33.4	32.7	35.4	32.1	27.0	25.5	28.0	30.0	28.5
Social security contributions	7.7	8.7	8.5	9.4	9.6	9.4	8.9	9.8	9.6	9.5	9.6
Payroll (manpower) taxes	2.9	2.7	2.9	3.1	3.4	3.2	3.0	1.1	0.2	0.1	—
Property taxes	2.6	2.8	2.9	2.6	4.0	2.9	2.8	2.7	2.5	2.5	2.6
Taxes on goods and services	46.8	44.4	42.3	40.8	38.3	42.1	46.7	48.9	48.2	47.2	47.6
Taxes on international trade	3.1	2.9	2.8	3.1	1.8	1.9	1.6	1.5	2.0	1.5	1.5
Other taxes	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.4	0.2	0.3	0.3
Nontax revenue and grants	7.3	7.4	7.0	8.0	7.2	8.1	9.6	10.1	9.4	9.0	9.9
Total Expenditure											
(as a percentage of GDP)	25.5	24.5	25.5	30.1	31.1	32.0	30.5	30.0	29.5	29.6	30.6
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	22.7	22.4	21.2	20.2	19.7	18.9	19.9	19.7	20.5	20.2	20.4
Of which:											
Wages and salaries	12.7	12.4	11.8	11.0	11.1	10.5	10.8	10.6	10.6	10.8	10.8
Interest payments	1.9	1.7	1.1	0.8	0.8	1.1	1.4	1.9	2.1	2.4	2.9

Subsidies and other current transfers	54.6	55.1	57.8	57.7	59.3	59.5	62.2	63.5	61.5	63.1	63.8
Of which:											
Social security funds	17.9	18.2	18.6	16.4	16.8	16.5	17.1	15.9	15.3	16.1	17.4
Capital expenditure	15.1	13.9	13.4	13.4	11.3	11.2	10.7	10.2	10.0	9.9	9.7
Lending minus repayments	5.7	6.9	6.5	7.9	9.0	9.4	5.8	4.6	6.0	4.3	3.3
Surplus/Deficit (as a percentage of GDP)	1.2	2.9	0.8	−2.2	—	−1.5	−1.9	−2.6	−2.0	−1.0	−2.0
Financing:											
Abroad	−0.1	−0.2	−0.2	0.4	0.5	0.6	2.1	1.4	0.8	1.1	1.1
Domestic	−1.2	−2.6	−0.6	1.8	−0.5	0.9	−0.2	1.2	1.2	−0.1	0.9
Monetary authorities	—	−0.9	−0.3	1.0	0.3	0.2	−0.4	−0.4	—	0.1	—
Deposit money banks	−0.7	−1.1	−0.4	1.2	−0.9	0.1	−1.0	0.8	0.2	−0.5	0.3
Other[1]	−0.5	−0.7	—	−0.3	0.2	0.7	1.2	0.7	1.0	0.4	0.7
Memorandum Items:											
General government expenditure and net lending/GDP	34.5	33.7	34.8	40.3	41.4	42.9	40.8	40.1	39.9	40.4	41.9
Central government debt outstanding/GDP	6.6	4.5	3.0	3.5	3.9	5.2	8.5	9.1	9.3	10.1	12.3

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

[1] Includes adjustments.

EXPENDITURE

Total expenditure as a percentage of GDP rose from 25½ percent in 1972 to 32 percent in 1977. In that year, a medium-term economic program was introduced which, inter alia, aimed at reducing the relative size of the government sector; since then, the share declined and was 30½ percent in 1982. The relative expansion of the central government sector over the period as a whole is among the smallest for this group of countries. Expenditure on goods and services, one half of which is wages and salaries, declined as a share in total expenditure from 22½ percent to 20½ percent, but kept pace with GDP growth. Interest payments on the public debt declined as a proportion of total expenditure in the first half of the period but rose subsequently and were 3 percent of the total in 1982, compared with 2 percent in 1972. Subsidies and current transfers, by far the largest economic category, increased their share in total expenditure from 54½ percent in 1972 to 64 percent in 1982. The increase largely reflects extensive reforms of pension schemes, increased transfers to local governments for various purposes, growing unemployment compensation payments, and other forms of labor market support. The proportion of capital expenditure to central government expenditure declined over the period, from 15 percent in 1972 to 9½ percent in 1982; it also declined somewhat as a proportion of GDP. Net lending rose steadily from 5½ percent of total expenditure in 1972 to 9½ percent in 1977, but subsequently fell sharply to 3½ percent in 1982. This category, which includes housing loans, inter alia, thus accounts for a major part of the decline in the share of total expenditure in GDP since 1977.

REVENUE

Between 1972 and 1982 the ratio of central government revenue to GDP rose from 26½ percent to 28½ percent. This 2 percentage point rise is the smallest relative increase experienced in any of the smaller industrial countries during this period. The figure conceals a much faster expansion up to 1976 when the ratio was 31 percent, but measures under the economic program initiated in the following year reversed the trend. As is reflected in the figures for 1972–82, income taxes, social security contributions, and payroll taxes were the principal objects of the official policy to reduce the tax burden; they also played a considerable role in the interaction between tax and incomes policies, as is discussed below. Income taxes, which accounted for 29½ percent of total revenue

in 1972, rose to 35½ percent in 1976, and subsequently declined to 28½ percent in 1982. Similarly, social security contributions and payroll taxes combined, which rose from 10½ percent of total revenue in 1972 to 13 percent in 1976, fell to 9½ percent in 1982. Taxes on goods and services, the most important tax category in terms of revenue yield, followed a reverse pattern. Their share in total revenue fell from almost 47 percent in 1972 to just over 38 percent in 1976, and then rose steadily to 47½ percent in 1982. The most important of the taxes on goods and services is a general sales tax, which yields about half the revenue in this category; the other half is accounted for largely by a range of excise taxes and levies. Property taxes and taxes on international trade accounted for 2½ percent and 1½ percent, respectively, of total revenue in 1982, and nontax revenue and grants increased their share in the total from 7½ percent to 10 percent over the period. This category includes property income from nonfinancial public enterprises and various administrative fees and charges.

THE FISCAL BALANCE AND ITS FINANCING

After registering surpluses during 1972–74, government finances swung into a deficit in 1975 that amounted to 2 percent of GDP. Since then, with the exception of 1976 when approximate balance was achieved, yearly deficits ranged from 1 percent to 2½ percent of GDP. Sharp increases in various transfer payments for social welfare and in support of certain export industries were a significant contributory factor to the deteriorating fiscal position, as were measures to reduce the tax burden during the latter half of the period. The fiscal surpluses of 1972–74, which had accumulated both in a countercyclical fund and as other deposits held with the Bank of Finland and the Post Office Bank, were drawn down sharply to finance part of the 1975 deficit, entailing a large liquidity expansion that created problems for monetary policy. About one fifth of the 1975 deficit was financed from external sources. From then on, borrowing abroad assumed an enhanced role, frequently covering one half or more of deficit financing. The Government has no automatic access to central bank credit, and domestic borrowing is mainly in the form of bond sales to the public and direct borrowing from private financial institutions. Despite fiscal deficits in the past several years, central government debt as a proportion of GDP rose only slightly over the period and was 12½ percent in 1982—the second lowest ratio among the smaller industrial countries after Luxembourg.

FISCAL POLICY

The framework. In 1982, total general government expenditure was equivalent to 42 percent of GDP, of which the Central Government accounted for 30½ percent when transfers to other levels of government are included. The size of this share implies a relatively large local government sector compared with other countries in the group. Although the municipalities formally enjoy a high degree of autonomy, the Central Government exerts substantial influence on their financial decisions in two ways: first, through transfers from the central government budget that are regulated by law, and, to some extent, by budget instructions and sectoral plans relating to such areas as health and welfare services, which are financed on a cost-sharing basis (these transfers amount to approximately one third of total revenue of local governments); second, through the practice of negotiating limits on expenditure growth for a few years ahead with the central organizations of municipalities. A series of such agreements was negotiated over the period and have proved quite successful; growth targets have been generally observed, although local government current expenditure has posed problems. The budgets of local authorities are balanced as a rule by a flexible application of the proportional local income tax whose rate is set so as to cover all financing needs not met by other revenue sources.

The central government budget is thus the major tool of fiscal policy. It tends to focus on medium-term objectives in the framework of multiyear budgeting, which has been practiced in Finland since the late 1960s. The forecasts cover four- or five-year periods and serve as informal guidelines in the preparation of the annual budget without constituting future expenditure or revenue commitments on the part of the Government. From time to time the medium-term forecasts are incorporated in a government report on economic and fiscal policy that is presented to Parliament for discussion but not for decision. The nonbinding nature of the multiyear planning has preserved a measure of flexibility in fiscal policy, which is largely exercised through a frequent use of supplementary budgets. These budgets usually provide for adjustment of spending and borrowing levels in line with actual revenue and other developments within the fiscal year in an effort to maintain the appropriate medium-term course.

The annual and multiyear budgeting process is supplemented with the use of econometric models as tools of fiscal analysis. Two analytical approaches are used. One, the high employment budget balance, ab-

stracts from the cyclical position of the economy and the workings of automatic stabilizers to estimate the impact of policy changes on aggregate activity. The other approach, the weighted budget balance, provides an alternative measure of the different budgetary impact, allowing explicitly for different impacts of separate expenditure and tax measures on the growth of real GDP.

A special feature of fiscal practices in Finland is the involvement of the Cabinet in advance expenditure control. A committee of key ministers deals with all major expenditure decisions within the year, including decrees, budgetary instructions, bills entailing expenditure, and other matters of financial significance. This is an informal procedure that ensures the provision of information on key issues and provides a basis for efficient financial control at the highest level.

Special countercyclical devices not strictly within the realm of fiscal policy have been applied over the period. Mention has already been made of the government countercyclical fund, introduced in 1970. This policy instrument has been used infrequently since the mid-1970s, however, and is considered fairly inflexible, as each transaction requires parliamentary approval. Countercyclical deposit schemes in various forms have been used more effectively. One is an investment reserve scheme, under which firms can transfer a certain proportion of their profits free of tax as interest-bearing investment reserves with the central bank. Release of the reserves is at the discretion of the Government within a specified maximum period. Similar schemes of a compulsory nature and applicable generally or to specified types of business income have also been adopted. The terms and conditions of voluntary and compulsory schemes have varied over the period.

Aims and measures. An overriding aim of fiscal policy throughout the period was full employment. In the early 1970s, the rundown of countercyclical funds, accumulated in periods of fiscal surpluses, largely served this purpose, the relevant expenditure measures, such as public works projects, frequently being introduced in supplementary budgets. Special emphasis was placed on alleviating regional unemployment by supporting construction in the northern and eastern parts of the country. Fiscal policy also concentrated on the fight against inflation, which was largely pursued in the context of incomes policy; fiscal measures were applied on both sides of the budget in an endeavor to moderate wage settlements and thus reduce inflation through the cost side.

Another high-priority aim of fiscal policy was to help restore external balance through selective export-promotion measures as well as a general tightening of the fiscal stance when conditions so required. Stimulatory fiscal policy pursued until the mid-1970s, in anticipation of an early world recovery, was associated with growing external deficits and accelerating inflation. To counteract these trends, fiscal policy assumed a restrictive stance in 1976, which resulted in a marked strengthening of the external position but, at the same time, contributed to domestic recession and rising unemployment. These adverse developments prompted the authorities to introduce a medium-term stabilization program in mid-1977, the main objectives of which were to simultaneously stimulate employment and the output of the enterprise sector and restrain the share of taxes and public expenditure in the economy. In other words, recovery was to be based on expansion of the enterprise sector and restraint in the growth of the public sector. A special fiscal ingredient of the medium-term strategy was the setting of maximum targets for public expenditure growth in real terms, reinforced by agreements with local authorities, with a view to arresting expansion of the public sector's share in GDP. Also, a target was adopted for revenue growth based on keeping the tax ratio to GDP at its 1977 level. This policy, which was generally successful, was maintained for the remainder of the period.

Apart from the general measures mentioned above, several specific fiscal measures were taken at different times over the period. Among those to stimulate business activity and employment were cost guarantee compensation payments to shipbuilding and other engineering industries to cover them against the risks of loss on exports owing to rises in the domestic cost level; grants to firms hiring persons on the unemployment register on a permanent basis; a series of reductions in employers' social security contributions; liberalization of investment reserves in the central bank; labor training and support to firms in depressed areas; and granting of loans on employment policy grounds.

The fiscal measures associated with the implementation of incomes policy included, on the revenue side, a series of selective income tax reductions followed by a general indexation of income taxation in 1977 and reductions in employees' social security contributions. Expenditure measures in this context included improvements in pensions, child and maternity allowances, increases in unemployment benefits, and consumer subsidies. Apart from these, the policy of increasing and extending social security benefits, which had received strong impetus

from the expansionary fiscal policy stance of 1975, was pursued in its own right throughout the period.

Overview and implications for future policy. Despite an unstable economic environment, fiscal policy in Finland is formulated in a medium-term context through nonbinding multiyear planning. However, within this framework fiscal policy tends to react to actual developments as they occur within the fiscal year through a frequent use of supplementary budgets. While ensuring a measure of flexibility in the pursuit of fiscal policy, this strategy is liable to accentuate the problem of reconciling short-term and medium-term objectives and to bring an element of inconsistency to policy implementation. Such a situation has emerged from time to time when, for example, the impact of restrictive measures to counteract rising prices and widening deficits on the external current account has been subsequently reduced by measures to promote full employment.

Among the outstanding features of fiscal developments is the containment of the public sector, a policy that was pursued successfully in the latter half of the period under review. The environment for private sector activity, although heavily influenced by exchange rate and incomes policies, was undoubtedly helped by the containment of the tax burden. Ambitious social reform policies were pursued throughout the period, generating sharp increases in government expenditure. Commitments already made to continue reforms of the school system and pension schemes will, together with the aging structure of the population, exert an upward pressure on expenditure in future years.[1]

Another feature of fiscal developments over the period was the close interaction of fiscal and incomes policies. Whatever the beneficial impact on cost developments, the tax reductions and the increased social spending this policy mix entailed contributed significantly to the deterioration in the fiscal position. This deterioration, a cause for growing concern, was accentuated by the large monetary financing of the deficits. Servicing of the government debt, although moderate by international standards, is an additional factor that will impose a growing burden on the budget in the medium term.[2] However, the foundation laid in previous years should place Finland in a relatively good position to deal with these fiscal problems.

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[1] Finland, Ministry of Finance, "A Survey of the Prospects for the Finnish Economy and State Finances to 1986" (Helsinki, 1982), pp. 36, 47.

[2] "A Survey of the Prospects for the Finnish Economy and State Finances to 1986," p. 33.

6

Iceland

Iceland's growth performance depends largely on unstable fish catches and world market prices for fish products, which are subject to sharp fluctuations. Despite substantial diversification of export production over the last decade and a half, fish products still account for 75 percent of total exports, which, in turn, amounts to one third of GDP. The impact of the two oil crises on the highly open economy was mitigated by the country's rich hydro and geothermal energy sources, which were developed rapidly over the period. Real GDP growth, albeit uneven, averaged almost 4 percent a year during 1972–82, although it actually fell in two of those years, owing to reduced fish catches. Due to the instability of export prices and the impact of oil price increases on the country's terms of trade, national income has undergone substantially greater fluctuations than GDP.

Full employment was an overriding aim of economic policy during the period. As a result of a high level of investment and accommodating exchange rate and financial policies, the rate of unemployment was kept at or below 0.5 percent in all years except 1982 when it reached a peak of 0.7 percent. This is the second lowest level of unemployment achieved in the smaller industrial countries—only Luxembourg had a lower rate.

By contrast, Iceland suffered the highest inflation rate of any industrial country over the period, with rates ranging in most years between 30 percent and nearly 60 percent. Sharp increases in fishermen's incomes in individual years, the working of a demonstration effect throughout the rest of the economy, and widespread indexation mechanisms constituted a vicious circle that sustained these high rates of inflation, which at times were further fueled by external price shocks. In all years except 1978, the external current account was in deficit, peaking at 11 percent of GDP in 1974 and 1975. After a marked

Iceland: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	6.5	7.9	4.0	−0.5	3.5	5.8	3.9	4.1	4.1	2.2	−1.3
Rate of unemployment	0.5	0.4	0.4	0.5	0.5	0.3	0.3	0.3	0.3	0.4	0.7
Consumer prices, percentage changes	9.7	20.6	42.9	49.1	33.0	29.9	44.9	44.1	57.5	51.6	49.1
External current account balance as percentage of GDP	−2.6	−2.8	−10.9	−10.9	−1.7	−2.5	1.3	−0.8	−2.3	−4.9	−9.6

Sources: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984; for rates of unemployment: Central Bank of Iceland, *Economic Statistics Quarterly*, November 1983.

Iceland: Consolidated Central Government Finances, 1972–82

(Year ended December 31)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue											
(as a percentage of GDP)	27.9	29.2	29.2	29.7	28.3	27.4	29.0	30.2	29.6	31.1	32.9
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	17.3	17.2	12.2	8.8	9.3	8.0	9.8	12.3	10.7	10.6	11.1
Social security contributions	4.8	3.5	3.5	4.0	3.0	3.8	4.3	4.5	4.2	2.7	2.3
Payroll (manpower) taxes	3.8	3.5	3.9	4.6	4.8	4.8	4.7	4.6	4.4	4.5	4.5
Property taxes	2.9	2.8	2.4	2.3	2.8	2.8	2.9	3.9	3.9	4.1	3.9
Taxes on goods and services	34.3	32.0	40.3	46.4	48.1	47.9	44.8	43.2	46.9	47.5	47.1
Taxes on international trade	28.9	27.7	27.4	21.9	20.6	21.6	21.6	19.7	18.2	19.1	17.6
Other taxes	0.1	0.1	—	—	—	—	—	—	—	0.1	0.2
Nontax revenue and grants	7.9	13.2	10.3	11.8	11.4	11.1	12.0	11.8	11.7	11.4	13.3
Total Expenditure											
(as a percentage of GDP)	30.5	32.3	33.8	35.9	30.8	31.9	31.6	32.4	30.9	31.9	35.9
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	30.7	29.3	30.2	28.3	32.4	32.0	34.8	34.1	36.3	35.8	33.4
Of which:											
Wages and salaries	20.2	19.8	20.3	18.6	20.5	21.4	23.6	23.0	24.0	23.5	21.9
Interest payments	2.6	3.1	3.2	5.6	5.0	5.2	6.9	7.4	5.7	6.2	6.6

Subsidies and other current transfers	39.7	34.6	37.7	36.1	33.2	32.1	34.8	37.9	37.1	36.6	36.9
Of which:											
Social security funds	24.0	22.0	21.2	20.3	19.9	20.4	22.9	22.7	23.6	24.5	22.9
Capital expenditure	16.3	23.7	22.2	19.9	17.4	17.9	15.2	14.2	14.6	15.3	12.2
Lending minus repayments	10.6	9.3	6.7	10.1	11.9	12.8	8.3	6.4	6.3	6.1	10.9
Surplus/Deficit (as a percentage of GDP)	−2.6	−3.1	−4.6	−6.2	−2.5	−4.4	−2.6	−2.2	−1.4	−0.8	−2.9
Financing:											
Abroad	2.8	1.6	1.2	1.9	2.0	3.1	0.7	1.7	0.8	0.9	3.1
Domestic	−0.3	1.5	3.4	4.2	0.5	1.3	1.9	0.5	0.5	−0.1	−0.2
Monetary authorities	−0.9	1.0	2.9	3.0	—	0.4	0.9	−0.7	−0.3	−0.8	−0.7
Deposit money banks	0.1	0.1	—	—	0.1	−0.1	0.2	0.2	0.1	−0.1	0.1
Other[1]	0.6	0.5	0.5	1.2	0.5	1.1	0.8	1.0	0.8	0.9	0.4
Memorandum Items:											
General government expenditure and net lending/GDP	37.4	38.5	40.6	44.0	37.7	38.8	. . .	. . .	. . .	. . .	. . .
Central government debt outstanding/GDP	15.8	12.5	13.4	18.1	18.9	20.7	22.4	23.9	26.4	23.6	31.4

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.
[1] Includes adjustments.

improvement in 1978 and a satisfactory outcome in the following year, the deficit widened sharply and by 1982 amounted to 9½ percent of GDP.

EXPENDITURE

Between 1972 and 1982 the ratio of government expenditure to GDP rose by 5½ percentage points to 36 percent. An especially sharp expansion occurred in 1982 when lending operations soared and real GDP fell. This expansion of the government sector is nonetheless one of the smallest recorded in this group of countries. The growth pattern was highly irregular; during 1972–75, for example, the ratio to GDP increased from 30½ percent to 36 percent, reflecting outlays in connection with a natural disaster (volcanic eruption) in 1973 and a transfer of functions from local to central government in 1974. A more relaxed attitude to government spending by a government that took office in 1971 contributed further to this rise in government expenditure. Following two years of large current external deficits, measures were taken in 1975 and 1976 to reduce the fiscal imbalance; as a result, the expenditure/GDP ratio shrank by 5 percentage points in 1976 to 31 percent. The measures taken included substantial expenditure cuts that were legislated in 1975 and incorporated in the 1976 budget, and a special 2 percent additional sales tax earmarked for a special fund that financed natural disaster expenditure and later became a permanent part of the general sales tax. General expenditure restraint was subsequently exercised and the ratio was kept relatively stable through 1981.

The share of expenditure on goods and services in total expenditure rose from 30½ percent to 33½ percent during the period, and within this category wages and salaries rose from 20 percent to 22 percent of the total. While some of the increase stems from the transfer of functions from local government, it also reflects growing public sector employment and higher wages and salaries in that sector; a further contributor to this increase was a change in the definition of outlays for the operation of state hospitals, which had previously been treated as transfers, but were increasingly being incorporated in the budget as final expenditure. Interest payments increased from 2½ percent of total expenditure in 1972 to 6½ percent in 1982, despite a rapid erosion of the nonindexed component of domestic debt, which is mostly with the central bank. Subsidies and other current transfers declined as a proportion of total expenditure from almost 39½ percent to 36½ percent over the period. Although the change in definition mentioned above

explains some of this unusual decline, the main reason is negligible expenditure on unemployment benefits. Capital expenditure was kept at a relatively high, if unstable, level throughout the period, ranging from 12 percent to 24 percent of total expenditure. Net lending, which ranged between 6 percent and 13 percent of the total, represents in large measure relending by the Central Government for investment in domestic energy sources.

REVENUE

Total revenue of the Central Government expressed as a ratio to GDP rose by 5 percentage points between 1972 and 1982 to 33 percent. The importance of income taxes relative to other revenue sources declined sharply over the period from over 17½ percent of total revenue in 1972 to 11 percent in 1982. This decline reflects annual adjustments in tax scales to reduce or eliminate fiscal drag and periodic cuts in rates in an effort to moderate wage settlements. Income taxes in Iceland are substantially lower than in other industrial countries. The major revenue source of the Central Government is domestic taxes on goods and services, mainly a general sales tax at the retail stage and profits of the liquor and tobacco monopoly. Taxes in this category rose as a proportion of total revenue from 34½ percent to 47 percent between 1972 and 1982. Taxes on international trade, on the other hand, dropped from 29 percent in 1972 to 17½ percent in 1982, partly as a result of tariff reductions under the European Free Trade Association (EFTA) and EC agreements.

Social security contributions ranged between 2½ percent and 5 percent of total revenue during the period. These are borne entirely by employers and the self-employed, since contributions by employees, levied on a per capita basis, were abolished in 1971. Other tax revenue comprises payroll taxes earmarked to the State Housing Fund and property taxes, which, taken together, increased slightly from 7 percent to 8½ percent of total revenue over the period. Nontax revenue, which is mostly interest income and administrative fees and charges, accounted in most years for 10½ percent to 12 percent of total revenue.

THE FISCAL BALANCE AND ITS FINANCING

According to *GFS* data,[1] a fiscal deficit occurred every year of the period. As a percentage of GDP, the deficit widened from 2½ percent in

[1] Owing to different treatment of relending operations of the Central Government, data on the fiscal balance differ substantially from national sources. The latter treat

1972 until it peaked at over 6 percent in 1975, as a result of tax concessions and increases in consumer subsidies to facilitate wage negotiations, a sharp increase in loan-financed energy investment, and some relaxation in fiscal discipline. In subsequent years, general expenditure restraint and increases in indirect taxes reduced the deficit substantially. The lowest deficit of the period, less than 1 percent of GDP, occurred in 1981. Attitudes of policymakers to deficit financing have differed according to whether the Treasury proper or the investment and credit budget (see below) was involved. For the ordinary central government operations that exclude relending to autonomous public enterprises, recourse has been had to the central bank in the form of overdrafts on the treasury main account. Also, the sale of government savings certificates, which are price-indexed and carry tax privileges, has financed certain ordinary investments. But the largest financing requirement has arisen in connection with projects included in the investment and credit budget, chiefly investments for exploiting the country's rich hydro and geothermal energy sources. Foreign borrowing, with the Treasury acting as an intermediary, has been used entirely to finance these and other investments by public enterprises that are expected to service the debt out of own revenue. Financing of these projects has also been in the form of sale of government savings certificates to the general public and to financial institutions. Between 1972 and 1982, total debt of the Central Government expressed as a ratio to GDP rose from 16 percent to 31½ percent, and the foreign component of the debt rose from 10½ percent to 20½ percent of GDP.

FISCAL POLICY

The framework. The Central Government dominates public sector activity in Iceland. A fiscal reform in 1972 centralized public revenue and expenditure to a considerable degree, and in recent years, about four fifths of total public expenditure and revenue is accounted for at the central level. Thus, based on 1977 data, the size of general and central government expenditure relative to GDP was 39 percent and 32 percent, respectively. The main source of revenue of local governments is a flat-

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borrowing and relending as offsetting items that do not affect the balance, whereas in *GFS* relending is entered on the expenditure side (lending minus repayments), and borrowing in this context is treated as a financing item. As a result, the data presented here (*GFS*) exhibit a deficit for each year, which in most instances is, as a ratio to GDP, 2 to 3 percentage points larger than data from national sources indicate. Thus, according to the national sources, there were surpluses in 1972, 1981, and 1982.

rate income tax; local governments are free to vary the rate of the tax within a range of zero to 10 percent, and may also raise it to 11 percent with the consent of the Central Government. Owing to cost-sharing arrangements and restricted borrowing authority, local government investment is in large measure determined in the central government budget and in the public investment and credit budget.

Annual budgeting is based on a forecast of the national economy for the upcoming fiscal year. In recent years, the national economic forecasts have been presented to Parliament along with the central government budget, but as a separate document in which the Government states its economic policy. Owing to inherently unstable economic conditions, measures that may significantly affect the budget plan are frequently introduced in the course of the fiscal year. Despite recent legislation that provides for multiyear budgeting as a means of facilitating fiscal decision making, such exercises have not been performed so far. However, four-year plans for the communications sector have been prepared for a number of years. From the mid-1970s, public investment and credit budgets were prepared annually and presented to Parliament, first separately, and then, after the budget was passed; in later years, emphasis was placed on finalizing the two together to facilitate coordinated decision making in the relevant areas. The investment and credit budgets, which cover one year, include total public investment and its financing, as well as forecasts of available public funds for certain private investment, such as housing. The purpose is to coordinate investment and credit policies in the framework of specified price and balance of payments objectives, and generally to ensure consistency between the financial and real sides of the economy.

While inflation automatically influenced revenue more than expenditure in the early part of the period, due to a responsive tax system that relied heavily on ad valorem indirect taxes, this stabilizing property of the fiscal system has eroded in recent years. The reason is a proliferation of indexation mechanisms on the expenditure side and a growing tendency to enact legislation that provides for present and future spending commitments. It is estimated that about 70 percent of total expenditure is "uncontrollable," in the sense that this portion of expenditure at the central level cannot be affected except by amending laws and contracts. Flexibility in fiscal policy is further restricted by the link between the cost of living index, which reflects increases in indirect taxes, and wages and salaries and social security benefits, and also by the practice of earmarking certain tax proceeds.

Aims and measures. Traditional fiscal policy attitudes in Iceland are characterized by a strong urge to balance the budget.[2] Present-day concerns over the persistent inflation have added support to the traditional view that fiscal policy should be defensive, geared toward preventing fiscal deficits, rather than restrictive, in pursuit of substantial surpluses. A manifestation of this attitude is the positive balance[3] that budgets, as approved by Parliament, invariably show, although the intended balance often turns into a deficit during the fiscal year. The fiscal objective of price stabilization tends to be pursued by selective measures designed to affect the outcome of general wage negotiations.

The balanced budget approach, although not successful in preventing deficits in actual outturns, contributed significantly to expenditure restraint. For most of the period, this restraint took account of the expenditure/GDP ratio, although the Government did not announce a specific target until 1979, namely, to prevent the ratio from exceeding 30 percent in 1979 and 1980; this target was reached if relending operations are not counted on the expenditure side. Within the constraints imposed by efforts to prevent the budget from imparting undue stimulus to demand and adding to inflationary pressures, fiscal policy has aimed at improving social security benefits and redistributing income in favor of low- and middle-income earners.

Measures toward the above objectives have affected both sides of the budget. Reductions in the personal income tax have typically been introduced to ensure moderation in wage settlements. In 1974 a particularly sharp reduction caused the share of income taxes in total revenue to fall by 5 percentage points. To partially compensate for the revenue loss, the general sales tax was raised by 4 percentage points. A series of reductions in the personal income tax and increases in indirect taxes was implemented in subsequent years.

Consumer subsidies were also typically used to facilitate wage negotiations or generally constrain price increases. In the short run, these subsidies dampened the rise in the cost of living index to which wages and salaries and social security benefits were linked, as did increases in family allowances in the years when these allowances were incorporated in the index base. While social security benefits are indexed, additional measures to extend their coverage and increase

[2] Blöndal, pp. 56–58.

[3] According to the operational concept as distinct from the *GFS* definition (see footnote, pp. 144–45).

benefits in real terms were frequently taken over the period, sometimes in the context of incomes policy and sometimes separately. One such measure, which particularly burdened the budget, was the introduction in the mid-1970s of guaranteed and indexed minimum income limits for old-age and disabled pensioners.

Implementation of the measures noted above was not a continuous process, however. In 1976, for example, a mounting current external deficit induced the authorities to reduce the expansionary impact of the budget and both consumer subsidies and social security benefits were curtailed. Apart from frequent increases in indirect taxes to counteract deterioration in the fiscal position, legal authorizations to cut expenditure in the existing budget were granted occasionally, although the full extent of the authorized cuts was generally not realized. To reinforce the general effort at expenditure restraint, a month-to-month fiscal reporting and expenditure control system was introduced in the mid-1970s and was further developed in subsequent years.

***Overview and implications for future policy*.** The overall impression that emerges from the events during 1972–82 is that the application of fiscal policy for stabilization purposes was quite limited. The balanced budget approach was narrowly applied and did not prevent deficits, which, according to the *GFS* definition, were substantial in some years. This fiscal practice nonetheless made a major contribution to the general expenditure restraint that was exercised for most of the period under review. Within the constraints implicit in the general political preference for balanced budgets, selective measures to combat inflation and reduce external imbalances were taken, largely in the context of incomes policy through reductions in direct taxes and increases in consumer subsidies and social security expenditure. The effectiveness of this approach was diluted by the weakening of the fiscal position that resulted from these measures, as accompanying increases in indirect taxes usually were only partially compensating. A widespread indexation of significant expenditure categories and de facto indexation of income tax scales greatly eroded the automatic stabilization properties of the fiscal system. Moreover, increased reliance on indirect taxes that are included in the price index used for compensation purposes implied growing rigidities and narrowed the scope for fiscal policy action.

Despite the limited use of fiscal instruments for demand management, progress was nonetheless made in the pursuit of other fiscal objectives. In a situation of full employment, a virtual absence of unemployment benefits and a general expenditure restraint that was

reinforced by the balanced budget attitude prevented the expenditure/GDP ratio from rising appreciably and kept down the tax burden. Investment policy that emphasized exploitation of domestic energy sources greatly reduced the country's dependence on imported oil. However, much of the fiscal deficit as defined here stems from this policy, and the liquidity impact of foreign borrowing attached to energy projects aggravated the problem of monetary management.

If future fiscal policy is to be more instrumental in combating inflation, which is Iceland's main economic problem, a reversal of past tendencies toward indexation and rigidities in the fiscal system would seem to be required. An attempt in this direction was made in 1983 when a new government, facing a sharp acceleration of inflation and mounting external imbalance, suspended indexation of wages and salaries and social security benefits and imposed a statutory wage ceiling for two years. Further measures in this direction, such as the exclusion of indirect taxes from the price compensation index, could substantially enhance the effectiveness of fiscal policy in this regard. Decisions on such rearrangements are essentially political in nature, however, and would require a steadfast, long-run course of policy—unfortunately a rarity in a country subject to unstable economic conditions and frequent changes of government. A departure from the balanced budget approach in order to relate fiscal policy more closely to the cyclical position of the economy, although attractive from a theoretical viewpoint, would entail a substantial risk. The increased flexibility such a reorientation might permit would have to be weighed against an eventual loss of fiscal discipline that appears to have been instrumental in stabilizing the relative size of the government sector in the economy.

7

Ireland

Ireland recorded positive growth rates in every year from 1972 to 1982. The growth path was irregular, however, ranging between 2 percent and 8 percent a year, reflecting the vulnerability of the highly open economy to external influences. Foreign trade is equivalent to approximately one half of GDP. Although economic development was assigned the highest priority and fiscal policy was instrumental in stimulating economic activity, unemployment remained very high by international standards throughout the period. Registered unemployment rose from 6½ percent of the estimated total labor force at the beginning of the period to 8 percent in 1980, and even more steeply to over 12 percent in 1982, partly as a result of a switch toward restrictive economic policies to counteract growing imbalances in the economy. Over the period, the task of containing unemployment was rendered more difficult by a rapidly growing labor force.

Inflation has remained high, and the impact of the first oil price explosion was especially marked. Consumer prices rose from 8½ percent in 1972 to 21 percent in 1975. The inflation rate abated to 7½ percent in 1978, but in subsequent years, consumer prices surged upward, increasing by over 20 percent in 1981 and 17 percent in 1982. Factors contributing to the persistent price rises include the second oil price shock in 1978, depreciation of the currency against the pound sterling, increase in indirect taxation, and large increases in wage rates, especially in 1980. The external current account was in deficit throughout the period, ranging between 1½ percent and 15 percent of GDP; the largest deficits were registered during the three-year period to 1981. The policy response to adverse external influences on the economy and intensive fiscal measures to foster economic development resulted in large and continuous fiscal deficits over the period covered.

EXPENDITURE

Ireland's central government sector expanded more sharply over the period than in any of the smaller industrial countries. As a ratio of GDP, total expenditure rose from 36½ percent to almost 58 percent between 1972 and 1982. This rise accelerated in the 1972–75 period but stabilized during the following two years when the policy stance shifted in a less expansionary direction to phase out the current deficit. From 1977, when a new government resumed an expansionary policy to improve the employment situation, the expenditure/GDP ratio was on the rise, especially in 1980 when it grew by 5 percentage points. All expenditure categories, as classified by economic type, rose at a faster pace than GDP, but the relative significance of each category in total expenditure changed somewhat. Expenditure on goods and services declined from 20 percent to 16½ percent of the total, and wages and salaries, which account for more than two thirds of expenditure in this category, underwent a similar decline. However, growing public employment, stemming in part from the unemployment relief policy, led to an appreciable rise in the share of wages and salaries in GDP over the period. Interest payments on government debt rose as a share of total expenditure from 9½ percent to 15½ percent between 1972 and 1982. However, inflation had reduced the budgetary burden by eroding the stock of outstanding government debt in real terms.

Over one half of total expenditure is in the form of subsidies and other current transfers; their share in the total rose from 51 percent to 53 percent over the period, after having exceeded 54 percent in 1975. Although this increase is less dramatic than in many other countries, it nonetheless represents a substantial rise in relation to GDP. Demographic factors, including a reversal of a traditional net emigration pattern, unemployment and other social security benefits, as well as industrial support, contributed to the increase. Capital expenditure averaged almost 9 percent of total expenditure over the period, with small deviations in individual years. Net lending rose from 9 percent to 16 percent of the total between 1972 and 1974 and has since ranged between 7 percent and 9½ percent. The last two categories reflect in large measure the development effort, and, taken together, their share in GDP rose over the period.

REVENUE

Between 1972 and 1982, total revenue rose as a proportion of GDP from 31 percent to 42½ percent, which is substantially less than

Ireland: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	6.4	4.7	4.3	3.7	1.4	8.2	7.2	2.8	3.3	2.9	1.9
Rate of unemployment	6.4	5.9	5.9	7.8	9.3	9.1	8.3	7.4	8.2	10.1	12.2
Consumer prices, percentage changes	8.7	11.4	17.0	20.9	18.0	13.6	7.6	13.3	18.2	20.4	17.1
External current account balance as percentage of GDP	−2.2	−3.5	−9.9	−1.5	−5.3	−5.5	−6.9	−13.6	−12.0	−15.1	−10.9

Sources: Organization of Economic Cooperation and Development, *Economic Outlook*, December 1984; for rate of unemployment: Department of Finance, *Economic Review and Outlook*, various issues; and *Current Economic Trends*, various issues.

Ireland: Consolidated Central Government Finances, 1972–82

(Year beginning April 1st through 1973 and Year ended December 31 after 1973)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue											
(as a percentage of GDP)	31.1	31.1	32.0	31.9	35.3	34.3	33.8	35.0	38.6	40.0	42.6
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	28.1	29.0	29.1	29.7	30.1	31.1	31.6	32.1	32.8	32.9	31.0
Social security contributions	8.9	9.6	11.5	13.6	13.2	13.2	12.9	12.9	12.8	12.7	13.3
Payroll (manpower) taxes	—	—	—	—	—	—	—	—	0.2	0.1	0.7
Property taxes	3.2	3.0	2.8	2.4	1.9	2.0	2.0	2.0	1.6	1.6	1.5
Taxes on goods and services	32.5	33.0	31.1	29.9	30.1	30.0	29.8	26.6	24.8	23.9	25.6
Taxes on international trade	16.5	15.9	15.3	13.8	14.2	12.0	11.4	11.4	12.8	14.9	13.2
Other taxes	—	0.1	—	—	—	—	—	—	—	—	—
Nontax revenue and grants	10.8	9.4	10.3	10.5	10.4	11.6	12.2	15.0	15.0	13.9	14.6
Total Expenditure											
(as a percentage of GDP)	36.7	37.9	43.9	44.3	45.4	43.7	45.2	47.1	52.0	55.0	57.8
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	20.1	19.5	18.2	19.6	18.7	18.2	17.5	17.8	17.3	17.5	16.6
Of which:											
Wages and salaries	14.0	13.6	12.4	13.9	13.2	12.6	12.1	12.4	12.0	12.4	11.4
Interest payments	9.5	9.4	8.5	9.7	11.0	12.0	12.6	12.9	12.6	13.6	15.7

Subsidies and other current transfers	51.2	50.1	48.4	54.3	53.7	53.5	53.6	53.2	52.8	51.8	52.9
Of which:											
Social security funds	10.1	9.9	9.7	11.6	11.7	11.3	10.6	9.9	10.5	11.1	12.0
Capital expenditure	10.4	9.5	8.9	8.0	7.1	7.7	8.5	9.0	9.5	8.7	7.9
Lending minus repayments	8.8	11.5	15.9	8.4	9.5	8.6	7.8	7.1	7.8	8.5	6.8
Surplus/Deficit (as a percentage of GDP)	−5.6	−6.8	−11.9	−12.4	−10.2	−9.5	−11.5	−12.1	−13.3	−15.0	−15.2
Memorandum Items:											
General government expenditure and net lending/GDP	39.8	41.9	49.7	50.5	51.2	49.3	49.5	50.8	56.2	59.2	61.7
Central government debt outstanding/GDP	52.3	59.7	65.0	73.4	79.2	77.9	82.1	89.5	91.4	99.3	108.7

Sources: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984; for government debt data: national sources.

expenditure growth. The share of income taxes in total revenue increased steadily from 28 percent to 31 percent. Despite partial adjustments for inflation and successive tax relief measures to stimulate private investment, the impact of the progressive rate structure of the personal income tax more than outweighed the revenue loss. A special feature of the income tax system is the heavy concentration of the tax burden on wage and salary earners and the much lighter burden on farmers. The share of social security contributions rose from 9 percent to 13½ percent, which broadly matches the financing needs of the relevant social insurance schemes that are intended to be self-financing.

Domestic taxes on goods and services declined as a proportion of total revenue from 32½ percent in 1972 to 25½ percent in 1982 and did not keep pace with nominal GDP growth. Over half the revenue in this category is derived from a value-added tax (VAT) that was introduced in 1973 with Ireland's membership in the EC. Excise taxes, which account for most of the other revenue in this category, explain the slow overall growth and reflect the authorities' reluctance to raise the mostly specific rates in view of the resulting inflationary impact. Substantial increases in excises were implemented, however, toward the end of the period and in the VAT in 1982. Taxes on international trade declined from 16½ percent to 13 percent of total revenue over the period as customs duties were lowered in accordance with EC membership. Other tax revenue, mainly property taxes, accounted for 2 percent to 3 percent of total revenue. Nontax revenue, on the other hand, rose from just under 11 percent of total revenue and grants in 1972 to 14½ percent in 1982, reflecting mainly increased property income.

THE FISCAL BALANCE AND ITS FINANCING

As noted earlier, the central government finances were in deficit throughout the period. The deficit widened rapidly from 5½ percent to 12½ percent of GDP in the 1972–75 period when a strongly expansionary fiscal policy attempted to moderate the effects of the international recession on the economy. In response to mounting concern over rapidly growing expenditure and the monetary implications of the large deficits, the policy stance was shifted in 1976 to a less expansionary direction and the deficit was reduced to about 10 percent of GDP in that and the following year. A new government that took office in 1977 resumed an expansionary stance, however, in view of the deteriorating employment situation, and the deficit widened to 11½ percent in 1978. It continued to rise for the rest of the period and reached over 15 percent of

GDP in 1982. Information on deficit financing is not available from the basic statistical source (*GFS*), but there is evidence that in the early years of the period, domestic financing—the banking system and the nonbank private sector—covered four fifths of the borrowing requirement; the rest was financed abroad. The domestic capital market is small in relation to the size of the deficit, however, and in subsequent years over half the financing requirement was met by external borrowing. In 1981 and 1982, for example, three fourths and three fifths, respectively, of the exchequer borrowing requirement was met by external financing. The large and persistent fiscal deficits have implied mounting government debt. Expressed as a percentage of GDP, this debt expanded from 52½ percent to 108½ percent between 1972 and 1982, and a sharp expansion is foreseen in the near future as well as in the servicing of the debt. In 1982 the foreign component was 42 percent of total debt, having risen from 9 percent in 1972.

FISCAL POLICY

The framework. The central government budget is the dominant instrument of fiscal policy in Ireland. In 1982 the ratio of public expenditure to GDP was almost 62 percent, of which the Central Government accounted for over nine tenths, if transfers to other levels of government are included. Such transfers in turn amounted to almost three fourths of total local government revenue and grants in that year. This ratio has since risen, making local governments increasingly dependent on the Central Government for their revenue.

In the central government budget a clear distinction is made between current and capital expenditure and revenue; traditionally, the basic operational rule of fiscal policy was to balance current revenue and expenditure in each fiscal year. When deficits on current account threatened to emerge, the authorities took swift corrective action—often by introducing supplementary budgets. This approach was motivated by the need to avoid pre-empting resources to finance public investment as well as to contain inflation and limit the external current account deficit. Later events of both domestic and external origin caused the authorities to depart from the principle of balancing the current budget, and since 1972, substantial current budget deficits have emerged.

In 1969, in an effort to better control the growth of public expenditure and improve resource allocation, a system of program budgeting was introduced. The system was to be gradually extended to all government departments by fiscal year 1975/76. However, by that

time, experience with this innovation, including difficulties with conceptual aspects, systematic ranking of priorities, and the size of the administrative machinery required,[1] had led the authorities to abandon the idea, and no budget documents in this form were published. A new approach to budgeting was introduced in 1978. This involved an annual planning process by which expenditure priorities and policy options were set out in the context of medium-term growth potential and economic and social policy issues. This form of national economic planning was to provide a comprehensive framework for the allocation of funds in the annual budget. The underlying idea was to achieve a sustained reduction in unemployment, and for that purpose an ambitious 7 percent annual GNP growth target was set. In the event, the second oil crisis grossly upset basic assumptions of the plan, and it has not been worked out in this particular form since 1979.

Aims and measures. Promotion of economic growth through industrial development and reduction of unemployment has been the overriding goal of fiscal policy throughout the period. Another policy objective was to preserve living standards and redistribute income in favor of lower income groups by tax reductions and ambitious social welfare programs. Toward the end of the period, faced with growing internal and external imbalances, the Government, in an attempt to contain domestic cost increases, adopted an incomes policy approach to prevent excessive wage settlements; however, this approach met with little success and was subsequently abandoned.

Other prominent measures aimed at promoting industrial development and sustaining employment included direct capital outlays and investment loans. In the early 1970s, the public capital program accounted for approximately one half of gross domestic fixed capital formation, and by 1982 this ratio had risen to 60 percent. Among other measures introduced for this purpose were various tax allowances to stimulate private investment. In particular, as part of the authorities' industrial policy, liberal tax advantages were offered for export-oriented investments in the manufacturing sector. Thus, in 1981 the standard rate of corporate tax for manufacturing firms was fixed at 10 percent for the period to 2000. Also, the Central Government has provided funds for employment-creation schemes and encouraged capital expenditure by semipublic bodies to sustain employment. In addition, temporary

[1] Maurice F. Doyle, "Management of the Public Finances in Ireland Since 1961," *Public Budgeting and Finance*, Vol. 3 (Summer 1983), p. 75.

employment premiums were offered to employers recruiting from the unemployed. Capital expenditure has at times been used as a countercyclical instrument; however, its effectiveness has been limited by the employment situation and the emphasis on economic development, and expenditure control has taken the form of changes in the rate of growth of capital outlays in accordance with cyclical conditions, rather than of direct reductions.

The policy reaction to the first oil price crisis and the ensuing world recession was to preserve living standards and maintain employment. The public capital program continued to operate at a high level, and various social benefits were increased in real terms and extended, including reductions in the qualifying age for pensions and extensions of pay-related unemployment and sickness benefits. Personal income and company tax concessions were also granted and items were exempted from the value-added tax. The expansionary fiscal policy continued as the recession deepened. However, by 1976 concern was growing over the rapid expansion of government expenditure and the monetary impact of the widening fiscal deficit. The Government announced in that year that it intended to phase out the current budget deficit over a three-year period; to that end, it introduced several measures, including a sharp increase in indirect taxation. Similar announcements were repeated in subsequent years, but without material success, especially after 1977 when the new government that came into office in that year adopted a highly expansionary fiscal policy stance within the framework of the national economic plan referred to above. The fiscal stimulus generated by this plan was intended to be temporary, on the assumption that the private sector would react to achieve self-sustaining growth. The Government stated that containment of domestic cost increases in the context of national pay agreements was preferable to deflationary fiscal and monetary policies. This approach found expression in an agreement reached with the social partners in 1979 of a "national understanding for economic and social development." The agreement marked a departure from the traditional wage bargaining process in Ireland, in that it involved the social partners in the formulation of economic and social policy. The agreement included new tax concessions, increased social welfare payments, and higher wage increases for public employees. Not only did this approach further weaken the fiscal position, but it did not achieve its main objective of containing domestic wage costs. It was abandoned in 1981.

Since mid-1981, the stance of fiscal policy has tightened, as a widening fiscal deficit, associated with a sharp increase in the current external deficit, won growing public and political acceptance of the need to reduce public borrowing. The brunt of the fiscal adjustment effort has so far fallen on taxation rather than expenditure. The authorities have reiterated their intention of continuing their efforts on the fiscal front, with a view to eliminating the current budget deficit over a five-year period.

Overview and implications for future policy. During the 1972–80 period, expansionary fiscal policies characterized financial developments in Ireland. The justification for these policies is, in part, the perceived need for public sector initiative to stimulate overall economic growth and employment. Economic progress and the working of an international demonstration effect have at the same time generated increased demands for improved social security. In the wake of the first oil crisis, the official policy was to stimulate consumption; by that time the principle of current budget balancing had been dropped. Both policy decisions tended to weaken effective financial constraint on the growth of social expenditure, and entitlement programs were initiated that added to the inflexibility in public expenditure and constituted a severe drain on the budget. Unstable external influences have undermined attempts to set growth targets that, inter alia, would serve as a framework within which demands for public services could be met. Similarly, the setting of consistent policy objectives has been complicated by the different political priorities of governments. These factors exerted strong upward pressure on government expenditure, while revenue growth was hampered by a narrow income tax base, specific rather than ad valorem excise duties, and a depressed economy. On the whole, while fiscal policy has been countercyclical in recessions, it has tended to be procyclical during periods of expansion.[2] As a result, fiscal deficits have been experienced on a rising scale, with wide economic implications, not least for the external position and monetary policy whose stance was for the major part of the period largely determined by fiscal developments. Debt accumulation proceeded at a fast pace, and the size of government debt in relation to GDP is the largest among industrial countries.

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[2]Peter Bacon, et.al., *The Irish Economy: Policy and Performance, 1972–1981* (Dublin: Economic and Social Research Institute, 1982), p. 58.

While the medium-term objective of eliminating the current budget deficit poses a dilemma for fiscal policy because of the unemployment problem, the growing structural element in the fiscal deficit and the long-run implications for the development of the economy make this medium-term action highly desirable. In particular, debt servicing will constitute an increasing claim on budgetary resources in coming years and threatens to make the deficit and further debt accumulation self-perpetuating. Recent tax increases have narrowed the scope for further action on that front, so that the announced fiscal adjustment will have to concentrate on the expenditure side. The past record strongly suggests, however, that a satisfactory result would have to be associated with a major change in policy priorities and political attitudes to public spending.[3]

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[3]Since mid-1981, fiscal policy has remained less expansionary and the exchequer borrowing requirement has been reduced. This restrictive posture was maintained despite three changes of government over a period of 18 months. The announced government objective of eliminating the current budget deficit by 1987 has been superseded by events. In early 1984, the authorities indicated their intention to reduce the current budget deficit and the exchequer borrowing requirement over the next three years in order to slow down the growth of public debt with a view to stabilizing the ratio of interest payments to both GNP and tax revenue.

8

Luxembourg

External influences predominate in the exceptionally open Luxembourg economy where foreign trade amounts to 85 percent of GDP, if services are included. The steel industry is the major contributor to exports and, although it has been declining over the period, it still accounts for about half of Luxembourg's exports. The shrinking of the steel sector called for substantial structural adjustment, which has been smoothly carried out by the rapid development of the financial sector, whose value added represents some 30 percent of GDP, and by a series of fiscal incentives.

After a strong growth performance from the late 1960s, the country experienced a deep recession in 1975 caused largely by a decline in world trade, especially in steel. Real GDP declined by 6 percent in that year. In subsequent years, real output growth fluctuated with world market conditions for steel, which again deteriorated in 1981 when real GDP fell by almost 2 percent. The rate of unemployment remained lower than in any other country in the group throughout the period; although some slackening in the employment situation occurred, unemployment did not reach 1 percent until 1981. To a certain extent, the successful employment policy was facilitated by a large foreign component in the labor force.

Annual inflation rates rose sharply to 10 percent to 11 percent during the 1974–76 period, on account of higher import prices and wage costs, reflecting, inter alia, a large upward adjustment in the minimum guaranteed wage in 1975. Price rises abated in the next two years, owing to more stable import prices and moderate wage settlements, but accelerated in 1979 and subsequent years, on account of a renewed

Luxembourg: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	6.2	10.8	3.6	−6.1	1.9	0.6	4.5	4.0	1.7	−1.8	−1.1
Rates of unemployment	—	—	0.1	0.2	0.3	0.5	0.7	0.7	0.7	1.0	1.3
Consumer prices, percentage changes	5.2	6.1	9.5	10.7	9.8	6.7	3.1	4.5	6.3	8.1	9.4
External current account balance as percentage of GDP	11.2	21.6	31.6	21.6	24.5	25.2	23.3	28.3	22.6	20.8	18.4

Sources: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984; for unemployment data: Organization for Economic Cooperation and Development, *Economic Surveys: Belgium-Luxembourg*, various issues.

Luxembourg: Consolidated Central Government Finances, 1972–82

(Year ended December 31)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue											
(as a percentage of GDP)	33.5	32.3	32.9	37.7	37.1	39.9	40.6	38.0	40.0	37.6	34.7
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	33.9	36.7	40.8	37.2	36.6	39.5	41.1	38.5	35.7	34.9	34.9
Social security contributions	27.7	26.6	26.8	29.0	30.3	29.2	27.5	28.0	26.0	25.8	25.2
Payroll (manpower) taxes	—	—	—	—	—	—	—	—	—	—	—
Property taxes	5.6	5.8	4.9	4.2	4.4	4.4	4.4	4.9	4.6	4.7	4.9
Taxes on goods and services	21.0	20.4	17.5	19.8	18.6	17.3	17.1	17.2	18.9	19.5	20.3
Taxes on international trade	0.4	—	—	—	—	—	—	—	—	0.1	0.1
Other taxes	0.5	0.4	0.4	0.4	0.4	0.1	0.1	0.1	0.1	0.1	0.1
Nontax revenue and grants	10.9	9.8	9.5	9.5	9.6	9.5	9.9	11.3	14.8	14.9	14.3
Total Expenditure											
(as a percentage of GDP)	32.1	29.8	29.0	36.7	36.8	39.4	37.8	38.2	39.3	37.9	35.8
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	22.7	23.1	23.7	22.7	21.7	21.1	21.8	21.7	22.1	19.6	22.6
Of which:											
Wages and salaries	17.9	18.9	19.4	18.2	17.8	17.7	18.0	17.9	18.1	15.6	18.7
Interest payments	3.1	2.8	2.4	1.9	1.8	1.9	2.1	2.0	1.9	1.9	2.0

Subsidies and other current transfers	58.9	57.5	57.6	61.4	61.9	63.1	63.0	62.4	62.8	64.8	63.7
Of which:											
Social security funds	40.7	39.5	38.0	40.3	41.2	40.8	41.6	40.3	40.9	40.5	39.5
Capital expenditure	13.5	15.3	13.6	11.8	11.5	10.2	10.7	11.1	14.4	12.6	11.9
Lending minus repayments	1.8	1.2	2.8	2.1	3.0	3.7	2.5	2.8	0.5	2.5	0.8
Surplus/Deficit (as a percentage of GDP)	1.4	2.5	3.9	1.0	0.3	0.6	2.7	−0.2	1.0	−1.6	0.5
Memorandum Items:											
General government expenditure and net lending/GDP	35.2	32.5	32.4	41.0	40.5	43.1	41.4	41.7	44.4	43.1	...
Central government debt outstanding/GDP	...	...	...	...	...	...	...	...	...	...	...

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.

Note: Due to a statistical adjustment to expenditure totals, figures do not add up during the period 1980–84; for the same reason surplus/deficit does not equal the difference between revenue and expenditure.

upsurge in oil prices, and reached 9½ percent in 1982. Large and continuous surpluses on external current account are a special feature of economic developments in Luxembourg. In most years since 1973, these surpluses amounted to the equivalent of 20 percent to 30 percent of GDP. Reduced export earnings of the steel industry and the increased oil bill were offset by a strengthening of the services balance, due to net investment earnings and earnings from banking, airlines, and Luxembourg Radio and Television.

The public finances were in surplus for most of the period, although the world recession and active fiscal policy to improve social services and facilitate the structural adjustment process contributed to the emergence of deficits in 1979 and 1981.

EXPENDITURE

From 1972 to 1982, consolidated central government expenditure expressed as a proportion of GDP rose from 32 percent to 36 percent. A sharp expansion, almost 5 percentage points from the base year, took place in 1975 as a result of a large increase in revenue (in large measure, revenue determines expenditure levels) and a new government's policy of increasing the public sector's role in the economy. Also, GDP declined sharply in this year, and despite resumption of positive growth rates in subsequent years, the share of expenditure in GDP continued to rise until 1977. It remained relatively stable thereafter. A large part of total expenditure is price indexed. Expenditure on goods and services, mainly wages and salaries, shared in this general expenditure growth in relation to GDP and remained a roughly constant ratio to total government expenditure at around 22 percent throughout the period. Subsidies and other current transfers increased their share in total expenditure from 59 percent to 63 percent during the 1972–77 period and stabilized around that level thereafter in response to a tighter fiscal stance. The abrupt increase in the total share of this category in 1975 is to a large extent reflected in social security outlays and subsidies to support employment and activity. The share of capital expenditure in the total fluctuated in the 10–15 percent range, while the share of interest payments on the public debt declined from 3 percent in 1972 to just under 2 percent in 1977 and has since remained at that level. The share of net lending fluctuated somewhat over the period and averaged just over 2 percent of the total.

REVENUE

The ratio of total revenue to GDP rose by 6½ percentage points from 1972 to 1980, but declined sharply in 1981 and 1982 to 34½ percent—only 1 percentage point higher than in 1972. Income taxes rose at a slightly faster pace, and their share in total revenue increased from 34 percent to 35 percent. Individual and corporate taxes shared equally in this relative growth, despite the linkage of individual taxes with the consumer price index since 1970. Corporate taxes, however, grew at a considerably faster pace between 1972 and 1978 and increased their share in total revenue from 10½ percent to 15 percent (12 percent to 16½ percent in tax revenue); they subsequently declined, as economic conditions deteriorated and tax incentives were granted to stimulate investment. Taxes on goods and services, almost entirely a value-added tax, declined as a proportion of total revenue from 21 percent to just over 20 percent, but more than kept pace with nominal GDP growth.

Social security contributions declined as a proportion of total revenue, accounting for 25 percent in 1982. The portions borne by employers and employees, 55 percent and 45 percent, respectively, remained roughly constant.

Nontax revenue accounted for 9½ percent to 15 percent of total revenue; the largest subcategory was property income in the form of interest on deposit funds, mainly social security funds. Property taxes remained around 5 percent of total revenue over the period. Other revenue sources are of lesser significance.

THE FISCAL BALANCE AND ITS FINANCING

From 1972 to 1978 central government finances were in surplus in every year. Expressed as a proportion of GDP, the fiscal surpluses ranged from a low of less than ½ of 1 percent in 1976 to a high of 4 percent in 1974. Since then, deficits were recorded in 1979 and 1981 only. This impressive fiscal record, achieved while expenditure was undergoing considerable growth, may be attributed in large measure to the budgeting practice of limiting that growth to the projected medium-term growth of revenue. The surpluses were used to build up reserves and to reduce the public debt. The emerging fiscal deficits toward the end of the period were financed by borrowing and by drawing on accumulated reserves. Borrowing on the domestic capital market was not considered likely to crowd out private domestic borrowers, as foreign participants dominate the Luxembourg capital market.

FISCAL POLICY

The framework. Luxembourg, like all other countries in the group, relies on the Central Government for the conduct of fiscal policy. The relative size of central and general government expenditure was 37½ percent and 43 percent of GDP, respectively, in 1981. About one half of local government expenditure was covered for most of the period by transfers from the Central Government. The scope for applying fiscal policy for countercyclical purposes is limited by the exceptionally large foreign trade sector, which, in the case of expenditure, implies low values of the domestic mulipliers. The authorities have nonetheless tried to mitigate the effects of cyclical variations through the use of multiyear financial programs that link the growth of government expenditure to the estimated trend growth of nominal GDP or to that of receipts. For the period 1970–75, for example, the financial program set a norm for the growth of expenditure, based on the trend growth of money GNP, which was to be kept unchanged throughout the cycle, implying that cyclical variations in the fiscal balance would be caused mainly by changes in receipts. During upswings, reserves accumulated in special investment funds and were drawn upon in times of recession to maintain the growth of expenditure according to the norm. In 1974, in a redirection of policy toward an enlarged role of the public sector in the economy, the medium-term strategy was changed. The new orientation linked expenditure to the expected medium-term growth of receipts rather than to the growth of nominal GNP, which implied a faster growth of expenditure. The countercyclical objective of fiscal policy was nonetheless maintained. In 1980, the medium-term strategy reverted to the linking of expenditure growth to that of nominal GNP. By that time, the enlarged role of the financial sector had entailed substantial net factor income from abroad (equivalent to 24 percent of GDP in 1977), and in the financial program special account was taken of the medium-term relationship between GDP and GNP. Of the 7½ percent norm for expenditure growth in the 1980 budget, for example, 1 percentage point was attributed to an adjustment factor for the GNP/GDP relationship.

Aims and measures. As implied by the financial programs, a major objective of fiscal policy was to exert a neutral impact on the economy over the medium term. Within this framework, the containment of prices, stimulaton of economic activity combined with promotion of industrial diversification, and improvement of public welfare con-

stituted major policy objectives, and throughout the period the maintenance of full employment was given high priority.

In the early part of the period, tax reductions, both personal income taxes and the value-added tax, were implemented to mitigate price rises; in the 1975 budget, for example, further reductions in these taxes were designed to stimulate the private sector, although the authorities generally accepted that stimulation of ecomomic activity through demand-management policies was not likely to be very effective in the highly open Luxembourg economy. By 1974 reduction of the public debt and accumulation of budget reserves were considered sufficient to justify an increase in the rate of growth of public expenditure relative to GNP growth. This change in approach enhanced the role of expenditure measures in the pursuit of fiscal policy. In the following recession years, various measures were introduced to keep up employment, including special public works projects, aid to the railways, which had experienced a sharp fall in their goods traffic as steel production fell, and subsidies to firms to compensate employees put on short-term work. Expenditure also increased sharply on account of transfers to the Unemployment Fund and a reform of the health insurance system.

Since 1977, efforts to restructure industry have been stepped up by means of fiscal incentives to investment and exports and by improving infrastructure, and measures have been taken to mitigate the effect of structural change on the employment situation, particularly in the declining steel industry. These include subsidization of about 20 percent of wage costs. Also, to counteract the adverse impact of these measures on labor mobility, a series of measures was introduced, such as a bonus for workers who voluntarily transfer to new industries, retraining aids, and early retirement schemes.

Facing a further decline in steel production, the authorities embarked on a major plan to restructure and modernize the steel industry, and a special law to this effect was enacted on July 1, 1983. This involved substantial increases in budgetary outlays in the form of capital endowments, assumption of interest payments on outstanding debt of the industry, purchase of bonds, and social transfers mainly on account of early retirement schemes. The rise in expenditure was to be financed from two sources: 40 percent each from increases in direct and indirect taxes and from remaining budgetary reserves, and 20 percent from exceptional borrowing.

Overview and implications for future policy. During a decade of unstable external conditions, economic management in Luxembourg

was remarkably successful, considering the strong external influences on the economy that necessitated large-scale structural adjustment. Fiscal policy played a significant role in this achievement, without incurring fiscal deficits for the larger part of the period. At the same time, however, the government sector expanded substantially, and the growing tax burden became a cause for concern to the authorities.

Toward the end of the period under review, fiscal deficits emerged as a result of the recession, which both slowed down revenue growth and caused increased budgetary support to the economy. Although financing of the deficit has not been a problem so far, the authorities are concerned, as the budget reserves have been progressively run down in recent years.

Despite the substantial budgetary burden emanating from the more recent restructuring plan of the steel industry, the authorities remain committed to a cautious stance of fiscal policy. This commitment is evidenced by their decision to finance a substantial part of the extraordinary outlays by increasing the already high tax burden. In the medium term, the fiscal position ought to return to equilibrium, given the present stance of policy.

9

Netherlands

During 1972–76, with the exception of 1975 when real GDP declined by 1 percent, economic growth was fairly strong in the Netherlands, averaging 4½ percent a year. Since 1977, however, growth rates have been sluggish and were in fact negative in 1981 and 1982, reflecting depressed domestic demand, with both private consumption and business investment in particular declining sharply in real terms. Also, a strong guilder caused problems for the manufacturing export industry, and depressed external conditions contributed to a recessionary climate in the open Dutch economy where foreign trade amounts to 45 percent to 50 percent of GDP.

The rate of unemployment was below 3 percent from 1972 to 1974 and rose moderately to 5 percent to 5½ percent in the following five years; however from 1980, unemployment soared, reaching 11½ percent in 1982. In addition to deteriorating economic conditions, a rapidly increasing labor force was responsible for this rise.

From 1972 to 1975, annual inflation rates rose from 8 percent to 10 percent. From 1976, however, the price performance was better than in most other industrial countries. The rate of inflation abated to just over 4 percent in 1978 and 1979, but subsequently rose somewhat in response to the oil price pressures. To a large extent, the good price performance in the latter half of the period is due to moderate wage settlements and the strong position of the guilder through its impact on import prices, reducing the wage-price spiral in a system of widespread indexation.

For most of the period, surpluses were recorded on the external current account. The strong energy sector in part explains this performance and, in particular, the sharp increase in the price of exported

natural gas. During the last two years of the period, however, the improvement in the external current balance was also the result of a drop in imports owing to depressed domestic demand. From approximate balance in 1973 and 1974, fiscal deficits grew year by year and in 1982 reached the equivalent of 7½ percent of GDP. For the last several years of the period, the Dutch experience thus represents the somewhat unusual case of growing fiscal deficits going hand in hand with rising external current account surpluses.

EXPENDITURE

Between 1973 and 1982 consolidated central government expenditure expressed as a proportion of GDP expanded from 46 percent to 59 percent, which is one of the highest rates of expansion among the smaller industrial countries over the same period. While individual expenditure categories did not share equally in this growth, they all increased at a faster pace than GDP, with the exception of net lending, which was unusually large in the initial year. The share in total expenditure of subsidies and other current transfers, mainly social security transfers—by far the largest economic category—increased from 66 percent to 70 percent from 1973 to 1982; this growth reflected the combined effect of demographic factors, such as aging population, extension of benefits—especially disability benefits—growing unemployment compensation, and indexation of benefits. In the recent past disability schemes that relate benefits to the degree of disability and previous income have been made more generous by an upgrading of degrees of disability, so that minor disablement qualifies for high benefits. Also in this expenditure category are subsidies to ailing firms, which increased substantially in the second half of the period.

Expenditure on goods and services declined as a proportion of total expenditure from 17½ percent in 1973 to 14½ percent in 1982, although within this category wages and salaries declined considerably less.

Interest payments on the public debt showed a continuous relative increase from 3 percent of total expenditure to 5½ percent over the period; a steadily widening fiscal deficit, as well as rising interest rates, accounted for this rise.

Capital expenditure as a proportion of total expenditure fluctuated in the 6–8½ percent range, and net lending amounted to 2 percent to 4 percent of the total, except in 1973 when it was 6 percent of total expenditure.

Netherlands: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	3.4	5.7	3.5	−1.0	5.3	2.4	2.5	2.4	0.9	−0.7	−1.7
Rate of unemployment	2.2	2.2	2.7	5.2	5.5	5.3	5.3	5.4	6.0	8.6	11.4
Consumer prices, percentage changes	7.8	8.0	9.6	10.2	8.8	6.4	4.1	4.2	6.5	6.7	6.0
External current account balance as percentage of GDP	2.8	3.8	3.0	2.3	3.0	0.7	−0.8	−1.1	−1.5	1.3	2.8

Source: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984.

Netherlands: Consolidated Central Government Finances, 1973–82

(Year ended December 31)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue										
(as a percentage of GDP)	46.0	47.3	49.6	49.8	48.4	48.4	48.6	49.9	50.5	51.3
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	32.3	32.3	32.1	31.1	31.0	30.3	30.3	29.7	28.2	27.4
Social security contributions	36.5	37.8	37.1	36.0	35.2	35.8	36.7	36.4	37.3	38.7
Payroll (manpower) taxes	—	—	—	—	—	—	—	—	—	—
Property taxes	2.0	2.0	1.7	1.8	2.1	2.3	2.4	2.2	1.9	1.6
Taxes on goods and services	22.2	20.4	20.1	20.4	21.3	21.5	20.5	20.1	19.0	18.3
Taxes on international trade	0.5	0.2	0.1	—	—	—	—	—	—	—
Other taxes	1.3	0.5	0.5	0.5	0.4	0.4	0.4	0.5	0.5	0.5
Nontax revenue and grants	5.1	6.9	8.4	10.2	10.1	9.8	9.8	11.1	13.2	13.6
Total Expenditure										
(as a percentage of GDP)	46.0	47.3	52.4	52.1	50.3	51.3	52.6	54.3	56.7	58.8
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	17.4	16.9	16.7	16.3	16.4	15.9	15.9	15.4	14.9	14.5
Of which:										
Wages and salaries	10.6	11.9	11.3	11.2	10.9	10.9	10.7	10.4	9.8	9.4
Interest payments	2.8	2.7	2.5	2.8	2.9	3.1	3.2	3.7	4.4	5.4

Subsidies and other current transfers	66.1	69.5	69.5	70.9	71.7	72.9	72.0	70.4	69.1	69.9
Of which:										
Social security funds	35.9	37.1	36.4	36.8	37.6	38.5	38.9	38.8	37.8	37.4
Capital expenditure	7.7	7.2	8.4	7.1	6.4	6.1	7.0	8.3	8.6	7.9
Lending minus repayments	6.0	3.6	2.9	2.9	2.5	2.1	1.9	2.2	3.1	2.3
Surplus/Deficit (as a percentage of GDP)	—	—	−3.0	−2.6	−3.0	−3.1	−4.6	−4.6	−6.5	−7.6
Financing:										
Abroad	—	−0.2	—	—	—	0.1	—	—	—	—
Domestic	—	0.2	3.0	2.6	3.0	3.0	4.6	4.6	6.5	7.6
Monetary authorities	−0.8	−0.7	0.7	—	0.1	0.2	0.8	−0.3	0.1	0.2
Deposit money banks	−0.4	0.2	0.9	0.9	0.5	0.3	0.9	0.8	1.3	1.5
Other[1]	1.2	0.7	1.4	1.6	2.5	2.5	2.8	4.1	5.2	5.9
Memorandum Items:										
General government expenditure and net lending/GDP	...	...	...	...	...	...	...	...	...	...
Central government debt outstanding/GDP	22.1	21.0	22.1	22.4	22.5	23.8	25.7	29.1	33.5	39.4

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1984.

Note: Due to overall adjustment to cash basis and statistical adjustment surplus/deficit deviates in many years from the difference between revenue and expenditure.

[1] Includes adjustments.

REVENUE

Total revenue of the Central Government increased as a proportion of GDP from 46 percent to 51½ percent during 1973–82. This ratio is substantially lower than the expenditure ratio, but is nonetheless the highest among the smaller industrial countries. Over the period, income taxes declined as a share in total revenue from 32½ percent to 27½ percent, and they also declined slightly as a proportion of GDP. The decline is in part explained by periodic adjustments for inflation to reduce fiscal drag and by a series of tax rate cuts to reduce the tax burden.

Social security contributions are the most significant single revenue source at the central government level. Slightly less than one half of the contributions is borne by employers and the rest by employees. These contributions respond to requirements of the social security system, which is self-financing, and show some year-to-year fluctuations over the period; they were as high as 38½ percent of total revenue in 1982, having risen from 36½ percent in 1973.

Taxes on goods and services, the most important of which is a value-added tax, declined from just over 22 percent of total revenue in 1973 to 18½ percent in 1982, and the proportion of these taxes to GDP also declined over the period.

The most dynamic revenue element is included in the category "nontax revenue and grants," whose share in total revenue increased from 5 percent to 13½ percent; this category also rose as a proportion of GDP from 2½ percent to 7 percent during 1973–82. This growth is largely accounted for by revenue from the sale of natural gas whose price soared over the period. Other revenue items, namely, property taxes, taxes on international trade, and other taxes, all declined as a proportion of total revenue. Taken together, the share of these revenue sources in the total was 4 percent in 1973, compared with 2 percent in 1982.

THE FISCAL BALANCE AND ITS FINANCING

As already observed, the central government finances incurred a deficit in 1975 after having remained in approximate balance in the two preceding years. The deficit remained the equivalent of roughly 3 percent of GDP for the subsequent three years but started to widen in 1979 and reached 7½ percent of GDP in 1982. These deficits reflect in part the budgetary impact of stimulatory measures in late 1974 to contain the rise in unemployment, which were followed later by various fiscal incentives to stimulate private sector activity, while the depressed state of the

economy in the past few years of the period limited revenue growth. That the authorities for most of the period pursued fiscal policy on the conceptual basis of a so-called structural budget deficit is relevant and is discussed in the next section.

The Government has had almost no recourse to direct external borrowing to finance the fiscal deficit, although in some years a substantial part of the government debt was taken up by nonresidents. At the beginning of the period, debt management policy was actively pursued to counteract the impact of capital inflows on domestic liquidity. The Government borrowed heavily on the capital market and repaid domestic short-term debt to the monetary authorities and deposit money banks. Domestic nonbank financing continued to be significant throughout the period, but from the mid-1970s, the banking system and the monetary authorities began assuming a role in financing; the importance of these sources fluctuated from year to year in the range of 10 to 50 percent of the central government borrowing requirement. In the last years of the period, the continuing recourse to monetary financing led the authorities to center on the actual budget deficit in the formulation of fiscal policy, rather than the structural budget deficit. Total debt of the Central Government increased substantially over the period. Expressed as a ratio to GDP, the debt expanded from 22 percent to 39½ percent between 1973 and 1982. As noted above, foreign borrowing was negligible.

FISCAL POLICY

The framework. While the activities of local governments are significant, from an economic viewpoint their financial autonomy is limited and the Central Government dominates fiscal policy formulation and implementation. In 1980 the ratio of general government expenditure to GDP was 62½ percent, and the Central Government accounted for almost 90 percent of this total, if transfers to other levels of government are included. Most current expenditure by local authorities is covered by appropriations from the Central Government. These revenue sources together with own sources generate, as a rule, surpluses on current account that finance part of the investments at the local level. These investments account for about three fourths of total public sector investment. Local authorities are also dependent on the Central Government for investment grants and loans, but in principle are responsible for arranging their own financing of investments not covered in the above manner. Such financing takes place through

borrowing in the domestic capital market directly or through the Bank for Municipalities. In practice, long-term borrowing is nonetheless subject to central government control.

Each year since 1969, the central government budget has been accompanied by four-year expenditure estimates. The multiyear estimates are intended as projections of existing expenditure policies without any commitment on the part of the Government. Experience suggests, however, that spending departments and various pressure groups do indeed interpret the projections as commitments; the multiyear estimates have thus constituted an upward pressure on spending, as well as an element of inflexibility in public expenditure.[1] The political structure and government decision-making procedure in budgetary matters may also put upward pressure on government spending. Coalition governments are the rule; cabinet members may not become or remain members of Parliament; and the cabinet votes on items in the budget, with the votes of all ministers ordinarily having equal weight.[2]

Macroeconomic forecasting in budget preparation has probably had more policy relevance in the Netherlands than in any other country in the group. Since 1961, fiscal policy formulation has rested on the conceptual basis of a so-called structural budget deficit. The growth of government expenditure and revenue is related to the medium-term trends in the economy, on the assumption that there is a steady trend growth of potential output and a stable structural pattern of savings and investment, as well as a stable trend in the external current account balance.

In essence, a "correct" balance was to be maintained between the budget position of the Central Government and the volume of investment and saving in other sectors of the economy that was consistent with a desired balance on external current account. Starting from a year considered to represent optimal balance, the size of the deficit in this base year was taken as a norm from which deviations were acceptable for cyclical reasons only.

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[1] L.J.C.M. LeBlanc and Th. A.J. Meys, "Flexibility and Adjustment in Public Budgeting: The Netherlands Experience," *Public Budgeting and Finance*, Vol. 2 (Autumn 1982), p. 60.

[2] Meys, "Spending More and Getting Less: Recent Experiences with the Allocation and Control of Public Expenditure in the Netherlands," in *The Grants Economy and Collective Consumption*, ed. by R.C.O. Matthews and G.B. Stafford (New York: St. Martin's Press, 1982), pp. 245–46.

The growth in tax receipts forecast on the basis of the trend growth of real national income and the progressivity of the tax system, as well as the increase in nontax revenue, provided the scope for expenditure increases or tax reductions, the so-called structural budget margin, with the budget deficit constant in absolute size (until 1973). In the calculation of this margin, allowance was made for price increases and expenditure components were treated differently according to their immediate impact on demand. However, general increases in wages and salaries were excluded from the budget margin calculation on the assumption that they would, in the long run, be covered by inflation-induced revenue increases. Forecasts of the trend growth of real national income were thus a significant determinant of the level of expenditure each year, as was the method of calculating the structural budget margin, which underwent a series of modifications over the period.

Amendments made in 1974 and 1975 with respect to norms for the structural budget deficit and the calculation method allowed a larger increase in expenditure, and subsequently amendments to achieve opposite results were formulated. The structural approach to fiscal policy gradually weakened, however, as growing imbalances in the economy obscured the distinction between cyclical and structural factors, and uncertainties in the external environment complicated the task of projecting medium-term trends in the economy. In 1980 the structural budget policy approach was abandoned for a more factual approach to the budget deficit, as mentioned above.

Aims and measures. The objectives of fiscal policy were closely connected with the emerging imbalances in the economy, which had assumed disconcerting proportions toward the end of the period. Ambitious social security schemes were promoted around the mid-1970s, but otherwise fiscal action centered on the problems of unemployment, depressed business activity, and inflation, although the emphasis differed from one time to another. Partly as a result of the policy pursued, fiscal developments themselves urgently needed structural adjustment.

Concern over high and rising taxation induced the authorities to announce the containment of the tax burden as a specific policy objective. Thus, in the 1972 budget the Government announced the policy of limiting the rise in the share of taxes in national income to 0.5 percentage point a year during 1973–77. Subsequently, this target was revised upward to 1 percentage point a year for 1976 and subsequent years, but in 1978 the norm was again changed and the

target was set to stabilize the collective burden (tax and nontax revenue as proportion of national income) at the 1978 level.

Over the period, various forms of tax reductions were implemented to achieve these targets. The type of tax affected usually reflected separate policy objectives. The measures included cuts in business tax rates, tax relief for business investment, and accelerated depreciation of industrial buildings outside the most densely populated areas. Some of these were temporary measures and all aimed directly or indirectly at stimulating investment and activity in the enterprise sector. Personal income taxes, apart from being periodically adjusted for inflation, similarly underwent a series of rate cuts to reduce their disincentive impact, and also to moderate wage settlements and thereby contribute to the containment of inflation.

The interaction of fiscal and incomes policies is a distinct feature of Dutch economic policy. To partly offset the resulting revenue loss, indirect taxes have been increased from time to time, such as the value-added tax in 1976 (from 16 percent to 18 percent), taxes on energy and tobacco; and as already noted, nontax revenue, mainly from the sale of natural gas, increased rapidly over the period. Natural gas export contracts are almost fully indexed to Rotterdam fuel oil prices, with up to a six-month indexation lag.

Specific targets have also been set for the medium-term structural and actual budget deficit. In 1976, for example, this target was set at 5½ percent of national income, of which 3 percent was attributed to the Central Government, and again in 1982, when a new government announced its aim of reducing the deficit by 1 percentage point a year over the 1983–86 period.

The policy of limiting the tax burden and reducing the deficit placed the brunt of the fiscal adjustment effort on the expenditure side. However, several obstacles have been encountered on this front. Efforts to contain social security transfers, the fastest growing category, were complicated by political controversies and protective sentiments that tended to intensify in economically adverse years, such as in 1980 when the maintenance of purchasing power of social security beneficiaries was announced as a special aim of fiscal policy. The general social security system includes a guaranteed minimum income equivalent to approximately US$760 a month. Also, containment of expenditure in this category was at one time complicated by a separation of revenue authority and expenditure responsibility. Moreover, major policy objectives were concerned with the reduction of unemployment and resump-

tion of economic growth by stimulating private sector activity, and the pursuit of these policies entailed vastly increased public spending. Measures to stimulate employment include special building projects, appropriations for local government investment, aid to social housing construction, subsidies to enterprises employing teenagers and to the clothing industry provided employment was kept at a specified minimum level, and wage-cost subsidy schemes for employing persons registered as unemployed for a specified minimum period of time.

Apart from tax incentives and wage-cost subsidies, the private enterprise sector receives various forms of selective and general government support. The oil crisis gave rise to the introduction in 1974 of special credit facilities for enterprises encountering liquidity difficulties on account of rising oil prices, and grants were made in the same year to small- and medium-sized enterprises in agriculture and horticulture to partly compensate for the adverse impact of the guilder appreciation on their incomes. Government support of a more general kind has taken the form of investment subsidies[3] operated since 1978 under the WIR (investment account) scheme, which is designed to affect the direction of investment by attaching different premiums to different types of investment and its location. Capital grants under the WIR scheme, and similar investment facilities in operation prior to 1978, increased sharply under deteriorating business conditions and rising unemployment in the second half of the period.

There is evidence that in addition to the factors mentioned above, certain other features of the budgetary process may have exerted an upward pressure on spending. First, as already mentioned, the multiyear expenditure estimates, contrary to intentions, are widely interpreted as minimum commitments on the part of the Government. Second, the structural budget approach has tended to assume unrealistically high growth rates for the economy, which form the basis for determining each year's expenditure levels in the budget. Attempts in recent years to cut expenditure were linked to these projected increases, which exceeded actual output and revenue trends, and thus had less than the intended effect on actual expenditure levels. A third, less tangible, factor is the impact of the political structure and decision-making procedures in budgetary matters as noted in the preceding section.

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[3]Government assistance is also offered in the form of loans and participation through semipublic institutions and commercial banks.

Overview and implications for future policy. Fiscal policy during the period was aimed at counteracting emerging imbalances in the economy and promoting generous social entitlement programs. The pursuit of both aims resulted in an explosive growth of government expenditure. Although the self-financing nature of the social security system pushed up contributions and added to a tax burden that is among the highest in industrial countries, attempts were made to reduce the tax burden, and revenue growth experienced a cyclical weakness in the past few years. As a result, the fiscal deficit widened—quite abruptly in the last years of the period. Imbalances in the economy increasingly assumed a structural character, which, according to prevailing views, could not be dealt with adequately by conventional demand management measures.

The vast diversion of resources to the public sector is widely seen as having harmed business profits and investment and overall economic growth and employment. The growing public sector borrowing requirement, which in 1982 absorbed 70 percent of the total supply of funds, contributed to the maintenance of high long-term interest rates, which also affected business investment adversely. The generous unemployment and other social security benefits are perceived as disincentives to work effort. Thus, taking account of the hidden unemployment element in these schemes, it has been estimated that the proportion of the potentially active population that is not working is as high as 20 percent.

These and other implications of past fiscal developments have engendered growing awareness of the need to reverse the trends by a substantial restructuring of the public finances. Although the authorities have long recognized this need and have repeatedly announced targets for limiting the tax burden and reducing the deficit, progress has been hampered by political controversies and also perhaps by technical forecasting factors regarding implementation of expenditure reductions, which lie at the heart of the adjustment effort. Regaining control over public expenditure, especially social security expenditure, is therefore likely to remain a major medium-term preoccupation of fiscal policy.

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New Zealand

Unstable and increasingly difficult export market conditions for New Zealand's agricultural products, which account for 70 percent of total exports, and the two oil crises occasioned considerable instability in the terms of trade, with repercussions on growth performance and price developments over the period covered. The impact was also reflected in sharp shifts in the stance of economic policy. After GDP had grown at over 6 percent on the average during 1972–74, a relative stagnation set in and lasted until 1980, reaching a low point in 1977 when real GDP declined by 5 percent. Growth resumed in 1980 and 1981, but declined by over 1 percent in 1982.

From 1972 to 1976, the rate of unemployment remained exceptionally low by international standards and never reached 0.5 percent of the labor force. Subsequently, and associated with the poor growth performance, unemployment began to rise and reached 5½ percent in 1982. Contributing factors were a growing incentive to register as unemployed to take advantage of unemployment benefits and an increase in the female participation rate that accounted for the entire increase in employment between 1976 and 1981.

The rate of inflation accelerated in the 1973–76 period, after which it varied from year to year between 12 percent and 17 percent, substantially above the average for industrial countries. This inflation reflects the impact of rising import prices, expansionary economic policies, and escalating wage costs outside periods of wage and price freezes.

Current external deficits were experienced every year since 1974. The position worsened sharply in 1974 when the deficit widened to 13 percent of GDP; it subsequently varied from year to year, from just under 2 percent of GDP to 8 percent. These deficits often caused concern

to the authorities and were frequently a major determinant of shifts in overall economic policy. The current external deficits and inflation were associated with high and sustained fiscal deficits resulting in large measure from an active fiscal policy to stimulate employment and economic activity.

EXPENDITURE

As a result of expansionary fiscal policy to counteract the recessionary impact of the first oil price shock, the ratio of government expenditure to GDP rose sharply from 31 percent to 40 percent between 1972 and 1975. The authorities grew concerned about the adverse impact of this policy on prices and the external current account position and shifted to a restrictive policy stance in the following year. As a result, the share of expenditure in GDP dropped by 5½ percentage points in that year. This share was unstable in subsequent years, but did not exceed the 1975 ratio appreciably until 1982 when it was 42 percent of GDP. The share of expenditure on goods and services in total expenditure declined from almost 31 percent in 1972 to just under 26 percent in 1982; within this category, wages and salaries, which had been at about 20 percent at the beginning of the period, declined to 17½ percent by 1982.

Interest payments on government debt declined from 7½ percent to 5½ percent of the total between 1972 and 1975, but rose thereafter and reached 11 percent in 1982. While this high level constitutes a heavy debt-servicing burden, the impact of large deficits and rising interest rates was substantially reduced by inflation, which eroded the domestic component of the debt.

Subsidies and other current transfers are by far the largest expenditure category. It rose from 43 percent to 53 percent of total expenditure over the period and was thus largely accountable for the rise in the relative size of the central government sector in the economy. Within this category, the largest items are social welfare expenditure, mainly pensions, and grants and subsidies to the manufacturing and agricultural (including forestry and fishing) sectors under various support schemes.

Capital expenditure declined as a proportion of total expenditure from 10 percent in 1972 to 5 percent in 1982; this category was often a major object of expenditure cuts in attempts to constrain overall spending, especially in the latter years of the period. Net lending grew sharply from just under 9 percent of total expenditure in 1972 to 17½ percent in 1975, but subsequently declined steadily to 5½ percent in

New Zealand: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	4.0	8.0	6.7	−1.1	2.9	−5.0	−0.6	0.7	2.0	4.0	−1.2
Rate of unemployment	0.2	0.2	0.2	0.4	0.3	1.6	1.8	2.2	3.6	3.5	5.4
Consumer prices, percentage changes	6.9	8.2	11.1	14.7	16.9	14.3	11.9	13.8	17.1	15.4	16.1
External current account balance as a percentage of GDP	2.9	0.2	−13.0	−8.0	−4.4	−3.8	−1.8	−3.6	−3.0	−5.1	−5.8

Sources: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984. Data on unemployment rates are derived from national sources. These, unlike other data in the table, have not been corrected for calendar variations (e.g., 1982 unemployment data refer to unemployment at the end of March 1983, i.e., the end of the fiscal year).

New Zealand: Consolidated Central Government Finances, 1972–82

(Year beginning April 1st)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue											
(as a percentage of GDP)	27.2	28.8	30.9	30.0	30.4	33.4	32.3	32.4	32.2	33.3	34.8
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	61.2	64.5	68.4	65.6	66.0	67.6	64.7	65.4	67.3	66.8	66.5
Social security contributions	—	—	—	—	—	—	—	—	—	—	—
Payroll (manpower) taxes	2.2	1.3	—	—	—	—	—	—	—	—	—
Property taxes	2.3	2.4	2.1	2.3	2.1	1.6	1.6	1.3	1.1	1.3	1.1
Taxes on goods and services	19.9	18.2	16.6	19.5	18.1	17.4	18.8	18.1	18.0	18.5	19.2
Taxes on international trade	4.1	4.6	4.6	3.6	3.5	3.2	3.4	3.5	3.2	3.7	3.4
Other taxes	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Nontax revenue and grants	—	—	8.2	9.0	10.1	10.1	11.5	11.6	10.3	9.6	10.7
Total Expenditure											
(as a percentage of GDP)	31.0	31.3	35.0	40.2	34.7	38.5	40.8	37.7	38.5	40.5	42.2
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	30.8	29.8	26.2	23.3	25.5	24.5	24.2	25.2	27.1	26.5	25.8
Of which:											
Wages and salaries	19.8	20.0	19.2	17.2	18.0	17.0	17.6	18.7	19.9	18.8	17.6
Interest payments	7.6	7.0	6.2	5.7	7.5	7.8	8.3	9.5	9.5	10.1	10.9

Subsidies and other current transfers	43.2	45.3	44.2	44.9	46.0	48.1	50.3	51.5	51.0	51.3	52.9
Of which:											
Social security funds	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Capital expenditure	9.8	9.4	11.2	8.5	8.3	7.7	6.8	6.0	5.9	5.4	5.2
Lending minus repayments	8.7	8.5	12.2	17.5	12.7	11.9	10.5	7.7	6.5	6.6	5.3
Surplus/Deficit (as a percentage of GDP)	−3.8	−2.5	−4.1	−10.2	−4.4	−5.1	−8.6	−5.3	−6.3	−7.2	−7.4
Financing:											
Abroad	−1.5	−0.3	2.9	3.5	1.6	2.3	2.9	1.9	3.4	2.3	2.7
Domestic	5.3	2.8	1.2	6.7	2.7	2.8	5.7	3.4	2.9	4.9	4.7
Monetary authorities	−0.1	0.5	2.3	2.3	2.3	−4.5	0.6	−0.2	—	2.1	−3.4
Deposit money banks	2.8	1.6	−0.2	3.6	−0.6	5.6	2.3	1.4	0.9	0.2	4.8
Other[1]	2.5	0.8	−0.9	0.8	1.1	1.7	2.8	2.2	2.0	2.7	3.3
Memorandum Items:											
General government expenditure and net lending/GDP	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Central government debt outstanding/GDP	44.6	41.2	41.8	47.8	44.7	48.7	50.5	49.2	47.6	49.2	58.2

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.
[1] Includes adjustments.

1982. The category includes such financial operations as the provision of budgetary funds for dwelling construction in line with the Government's policy of increasing the availability of housing for low-income families.

REVENUE

Total revenue of the Central Government rose as a proportion of GDP from 27 percent to 35 percent between 1972 and 1982. A striking feature of the tax structure is the significance of the personal income tax, which wholly accounted for this rise. During the period, its share in total revenue increased from 46½ percent to 58½ percent, which implies a 7½ percentage-point rise in its ratio to GDP. The rise was the result of the high rate of progressivity in personal income tax rates, which, in the inflationary environment, produced sharply increased yields despite measures to reduce fiscal drag and to supplement disposable incomes through reductions in tax rates and tax concessions in the form of increased exemptions. The share of the corporate income tax, on the other hand, declined from 14 percent to 6 percent of total revenue as a result of tax concessions and the recessionary conditions. The share of total income taxes in total revenue increased from 61 percent to 66½ percent over the period.

Another feature of the tax structure is the narrowness of the indirect tax base. Taxes on goods and services, mostly sales tax at the wholesale stage and excises, accounted for 20 percent of total revenue in 1972, but by 1981 this ratio had declined to 19 percent, which implies a growth rate somewhat higher than that of GDP. Within this category, however, sales tax revenue increased its share in total revenue from 8 percent to 11 percent, mostly on account of higher energy taxation. Property taxes are relatively insignificant at the central level and declined from 2½ percent to 1 percent of total revenue over the period. A payroll tax payable by employers on most remunerations was abolished in 1973 as part of a package to stimulate activity and reduce inflationary pressures. In 1972 and 1973 this tax yielded just over 2 percent and 1 percent, respectively, of total revenue. Taxes on international trade declined as a share of total revenue from 4 percent to 3½ percent between 1972 and 1982. Nontax revenue is mainly in the form of property income, income from nonfinancial public enterprises, and administrative fees and charges. Taken together, revenue from nontax sources averaged approximately 10 percent of total revenue over the period, with slight deviations in individual years.

THE FISCAL BALANCE AND ITS FINANCING

The central government finances were in continuous deficit throughout the period. During 1972–74 the annual deficit ranged between 2½ percent and 4 percent of GDP, but in 1975 it widened sharply to the equivalent of 10 percent of GDP as a result of a shift in the stance of fiscal policy. The stimulative impulse needed to offset the contractionary effects of the world recession and the deterioration in the country's terms of trade implied larger fiscal deficits than anticipated, however; as concern over the external position grew and inflation accelerated, the authorities shifted the fiscal policy stance to a less expansionary direction, and the deficit narrowed to 4½ percent of GDP in 1976. In subsequent years, the size of the deficit varied from year to year from 5 percent to 8½ percent of GDP, reflecting changes in both economic conditions and policy priorities.

Foreign borrowing was resorted to in every year since 1974 to finance the deficit; in most years, this borrowing covered between one third and one half of the financing requirement. Recourse to central bank financing was substantial during 1974–76, and again in 1981. Financing by deposit money banks varied greatly from year to year; from 1977 to 1981, it covered a declining portion of the deficit, but soared again in 1982. Nonbank financing, on the other hand, was a significant source of finance throughout. In the initial years of the period, nonbank financing took the form of sale of government debt to financial institutions under captive arrangements. Another method was the sale of bond certificates to the general public with associated tax incentives. Since 1977, nonbank financing has frequently covered one third of the financing requirement. Between 1972 and 1982, total debt of the Central Government rose as a proportion of GDP from 44½ percent to 58 percent, and the foreign component of the debt rose from 16 percent to 41½ percent.

FISCAL POLICY

The framework. As in other countries in the group, in New Zealand the Central Government plays a dominant role in the formulation of fiscal policy. The local governments have very limited autonomy, and their income and expenditure are closely controlled by the Central Government. Local government borrowing is also limited, requiring sanction of the Local Authorities Loans Board, which also determines interest rates on local government loans, subject to approval of the

maximum rate by the Minister of Finance. From time to time, action has been taken to restrict local government borrowing in these ways.

The scope of the Central Government for influencing public sector activity is also implicit in the relative size of its expenditure, which accounts for 85 percent to 90 percent of combined central and local government spending after consolidation. Moreover, in recent years, local governments derived almost one fifth of their revenue and grants in the form of transfers from the other levels of government, largely the Central Government.

The annual central government budget has on occasion been supplemented by minibudgets during the fiscal year to accommodate changed economic conditions since the budget was prepared and changes in policy priorities. As indicated earlier, this policy contributed to a fairly unstable pattern of expenditure growth over the period. Nonetheless, endeavors have been made to take a longer-term view in expenditure decisions, as manifested in the collection by the Treasury of three-year forecasts of real expenditure from the departments. These forecasts served the purpose of containing the overall growth of the public sector, as well as increasing flexibility in fiscal policy. The actual policy relevance of the three-year forecasts was limited, however, in that no direct link existed between annual budgeting and the forecasts. However, recent procedures imply that a closer link has developed between these two functions. A committee of officials on public expenditure is now responsible for ascertaining that the departmental forecasts represent a realistic assessment of existing government policy and for preparing a survey of government expenditure requirements over a three-year period. These surveys, along with estimates of the cost implications of proposals for the adoption of new policies, are treated separately by a cabinet committee. The three-year forecasts have in this way come to serve as a basis for determining future expenditure levels, although decisions are generally limited to the first year of the forecasts. To further improve existing budgetary techniques, a new approach is being considered, whereby expenditure levels would be determined primarily in a macroeconomic context.

Aims and measures. In the early 1970s, fiscal policy was relied on as the main instrument of stabilization policy. Full employment was a high priority objective, and in 1974 and 1975, achievement of this goal involved a highly expansionary policy stance that sought to counteract the impact of recessionary external trends on the economy through employment and demand-stimulating measures. The New Zealand

authorities took the view commonly held at the time that an expansionary policy was the proper response to the recession, as growth would soon pick up globally and a more normal policy stance could then be resumed. Indeed, around the mid-1970s, the Government announced that it did not accept deflationary policies as a solution to the weakening balance of payments position and declared its preference for measures designed to direct more resources to the export sector in the longer term, while meeting short-term and medium-term balance of payments needs by external borrowing. However, as it became increasingly clear that the world recession was more intractable than had been commonly anticipated, concerns mounted over the impact of the large fiscal deficits on the external position and on inflation.

Following a change of government in late 1975, greater emphasis was placed on promoting adjustment in the external sector and combating inflation. These objectives involved the pursuit of an incomes policy that at times took the form of a wage-price freeze, and fiscal measures, largely tax concessions and subsidies, were applied to promote exports. Also, to contribute to the balance of payments adjustment process, emphasis was placed on curbing expenditure growth, as the personal income tax was already very high and steeply progressive, and the scope for increasing indirect taxes was perceived as being restricted, owing to the impact on prices. After the abrupt upward shift in expenditure in 1974 and 1975, policies to curb expenditure growth succeeded in preventing the expenditure/GDP ratio from rising above that level for the remainder of the period covered, although the ratio fluctuated considerably from year to year. Within this policy restraint, however, the objective of maintaining a high level of employment continued to be given high priority, and additional measures were taken to improve social welfare benefits, the growth of which had assumed an automatic character through implicit indexation arrangements. Again in 1982 the authorities explicitly rejected stringent financial policies as a main instrument for restoring balance in the economy—on this occasion with emphasis on reducing inflation—as the likely costs in terms of unemployment and business failures were not acceptable.

Measures taken to stimulate demand and economic activity have taken various forms. Tax reductions are among the most prominent. A series of reductions in the personal income tax was implemented over the period for this purpose and also in support of incomes policy. These include reductions in rates, adjustments in tax scales to reduce fiscal

drag, and increased exemptions of various kinds. Measures affecting company taxation include abolition of the payroll tax, replacement of the progressive company tax structure by a flat rate tax, and increased tax-free investment allowances. Moreover, tax measures specifically aimed at directing resources into the export sector include special allowances for investment in plant and machinery to promote export production and other tax incentives for exports. Subsidies are also applied for this purpose. Other types of stimulative measures include government work programs, job creation and skill-promoting programs, and special measures to support the maintenance of farm production, inter alia, fertilizer subsidies and incentives for increases in livestock by tax deductions and concessionary loans. Measures directed at income redistribution in favor of lower income groups, but simultaneously serving the objective of stimulating demand and economic activity, include the provision of increased funds available for dwelling construction, and higher rates of social security benefits, in particular the introduction in 1977 of a national superannuation scheme.

Efforts to curb expenditure growth have relied on general restraint in budget preparation, a freeze on the number of staff in public employment, and general across-the-board cuts in expenditure. This last approach has had limited success, however, and it is widely felt that to be effective, such a measure would have to concentrate on more fundamental reductions in specific programs.

Overview and implications for future policy. Unstable economic conditions have been reflected in fairly frequent changes in the stance of fiscal policy and have generated an uneven growth path of fiscal aggregates, especially expenditure. Changes in policy priorities associated with changes of government may have contributed to this development. Although difficult to assess, since other factors, including external impulses, are involved, such changes entail the risk of impairing confidence in the firmness of the policy stance, with adverse repercussions on economic development. The move toward longer-term and macroeconomic orientation in fiscal policy formulation could contribute to a steadier course for the economy.

While the revenue/GDP ratio is one of the lowest among the smaller industrial countries, an unusually large share of total revenue is derived from the personal income tax, which is characterized by its steeply progressive structure. Despite a series of reductions over the period, the progressive rates ensured a continuous increase in the relative significance of this tax, owing to inflationary conditions. It is a widely

held view that the steep progressivity of the personal income tax rates has been detrimental to work effort and initiative, has encouraged incentives for tax avoidance and evasion, and has contributed to wage-push pressures and distortions in resource allocation. A corollary of the heavy reliance on the personal income tax is the fairly narrow base of indirect taxes.

In 1982 the Government initiated a tax reform aimed at eliminating these anomalies in the tax system by reducing progressivity in the personal income tax. Further broadening of the indirect tax base or increases in indirect tax rates and service charges were not considered advisable because of the associated inflationary reverberations. However, extension of the sales tax or the introduction of a value-added tax is under consideration. Continued efforts to reform the tax system along these lines would appear to remain a major objective of future fiscal policy.

As a result of persistently large fiscal deficits, total central government debt as a proportion of GDP was in the neighborhood of 50 percent in the past several years, rising to 59 percent in 1982, which is one of the highest ratios among the smaller industrial countries. The deficits have complicated the task of overall monetary management through their liquidity impact. Also, debt servicing imposes a substantial claim on budgetary resources and may be expected to rise in future years—one cause being that the foreign component of total debt, which is not subject to erosion by domestic inflation, has increased in relative significance over the period. Given the restraints on the revenue side, a satisfactory fiscal adjustment would have to rely heavily on discretionary cuts in expenditure components that are not affected by cyclical factors and whose unrestrained growth would perpetuate the fiscal deficit.[1]

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[1] The stance of fiscal policy was tightened by measures included in the 1984/85 budget. These included steep increases in service charges and indirect taxes, large reductions in tax expenditures, and a new tax on fringe benefits. The budget further provided for a comprehensive tax reform to be implemented over the next 18 months, which would involve a review of personal and corporate taxation and the introduction of a goods and services tax (VAT) in April 1986. It should also be noted that the significance of nonbank financing of the fiscal deficit has been increasing since 1980.

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Norway

Economic growth was higher in Norway in the 1970s than in most other industrial countries. From 1972 to 1979, GDP growth rates averaged almost 5 percent a year in reaction to rising oil activity and expansionary economic policies; these policies were designed to counteract recessionary external impulses that weigh heavily on Norway's economy, where foreign trade amounts to 30 percent of GDP. In 1981 and 1982, however, the world recession, slower growth of oil and gas production, and more restrictive domestic policies designed to reduce inflation and improve the external position kept growth rates substantially lower and more in line with the global experience.

Throughout the period under review, unemployment remained one of the lowest among the smaller industrial countries, with rates kept below 2 percent in most years. In 1981 and 1982, the stagnation of economic growth was associated with some increase in unemployment, however, although, at 2 percent to 2½ percent, it remained quite low by international standards.

Inflation was a persistent problem, despite intensive government involvement in wage negotiations and heavy reliance on fiscal measures to secure moderate settlements in the context of incomes policy. At times, this effort was supported by a temporary wage-price freeze. In the 1972–78 period, inflation rates ranged from 7 percent to 12 percent. Inflation abated to less than 5 percent in 1979 when a general price and incomes freeze was in effect, but accelerated in the following year, and in the three years to 1982, rates ranged from 11 percent to 13½ percent annually. Expansionary economic policy based on the prospect of substantial future oil export revenues led to steadily widening current external deficits, from near balance in 1972 to 14 percent of GDP in 1977.

Norway: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	5.2	4.1	5.2	4.2	6.8	3.6	4.5	5.1	4.3	0.9	1.0
Rate of unemployment	1.7	1.5	1.5	2.3	1.8	1.5	1.8	2.0	1.7	2.0	2.6
Consumer prices, percentage changes	7.2	7.5	9.4	11.7	9.1	9.1	8.1	4.8	10.9	13.6	11.3
External current account balance as percentage of GDP	−0.2	−1.8	−4.8	−8.5	−11.9	−14.0	−5.2	−2.1	2.0	3.8	1.2

Source: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984.

Norway: Consolidated Central Government Finances, 1972–82

(Year ended December 31)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue											
(as a percentage of GDP)	37.9	38.4	37.8	37.5	38.7	38.6	38.8	38.9	41.3	43.1	42.6
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	21.7	16.0	17.2	16.5	17.3	17.6	18.0	20.6	27.2	28.5	27.1
Social security contributions	19.8	27.2	26.9	27.2	25.5	25.6	25.7	25.5	22.1	21.8	22.3
Payroll (manpower) taxes	—	—	—	—	—	—	—	—	—	—	—
Property taxes	0.9	1.0	1.6	1.4	1.1	1.1	1.0	1.1	1.0	1.0	0.9
Taxes on goods and services	46.1	43.8	42.1	43.5	44.2	46.1	44.3	41.9	39.3	37.9	37.7
Taxes on international trade	1.5	1.5	1.4	1.3	1.0	1.1	0.9	0.7	0.6	0.7	0.6
Other taxes	—	0.3	0.5	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.2
Nontax revenue and grants	9.9	10.2	10.4	10.0	10.6	8.3	9.9	10.1	9.7	10.1	11.2
Total Expenditure											
(as a percentage of GDP)	39.4	39.3	39.1	40.7	44.6	45.4	45.6	45.2	43.1	41.0	41.8
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	19.2	18.8	18.8	18.7	17.3	16.8	16.5	16.0	16.0	18.0	17.6
Of which:											
Wages and salaries	10.9	10.7	10.1	10.1	9.8	9.3	9.1	8.6	8.4	8.9	8.9
Interest payments	2.5	2.5	2.8	2.3	3.6	4.1	4.8	5.7	6.4	6.3	5.8

Subsidies and other current transfers	61.9	62.2	62.2	61.4	59.6	59.8	62.4	61.9	60.4	62.4	63.4
Of which:											
Social security funds	33.5	34.4	33.6	33.1	31.3	29.3	30.7	32.2	32.8	34.8	35.5
Capital expenditure	4.4	3.9	4.0	3.8	3.5	3.6	3.6	2.9	5.3	5.0	4.7
Lending minus repayments	12.1	12.6	12.3	13.8	16.0	15.7	12.7	13.5	12.0	8.3	8.4
Surplus/Deficit (as a percentage of GDP)	−1.5	−0.9	−1.4	−3.2	−5.9	−6.9	−6.8	−6.3	−1.8	2.1	0.8
Financing:											
Abroad	−0.1	−0.3	−0.1	3.0	2.4	3.6	5.3	2.0	−0.8	−1.6	−2.1
Domestic	1.5	1.2	1.4	0.2	3.4	3.2	1.5	4.3	2.5	−0.5	1.3
Monetary authorities	−1.1	−0.5	—	0.7	1.2	0.5	0.3	—	−2.0	−1.0	−0.1
Deposit money banks	1.9	1.0	0.6	−0.6	1.5	1.9	1.5	3.2	4.3	1.2	−0.3
Other[1]	0.7	0.7	0.8	0.1	0.6	0.8	−0.3	1.1	0.3	−0.7	1.7
Memorandum Items:											
General government expenditure and net lending/GDP	56.2	56.2	55.9	58.8	60.7	63.0	64.4	63.2	55.8	52.2	52.8
Central government debt outstanding/GDP	28.1	26.8	24.8	25.7	27.8	33.1	38.4	42.1	37.0	32.1	26.5

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.
[1] Includes adjustments.

A deficit of this magnitude was regarded as unsustainable, however, and after a redirection of economic policy toward a more restrictive stance in 1978 and a continued rise in oil exports, the current external position improved sharply from a deficit equivalent to 5 percent of GDP in 1978 to a surplus of 4 percent in 1981 and over 1 percent in 1982. The central government finances registered deficits throughout the period, except in 1981 and 1982.

EXPENDITURE

The expenditure of the Central Government expressed as a ratio of GDP expanded from 39½ percent to 42 percent between 1972 and 1982, which is the smallest expansion of the central government sector among this group of countries over the period. However, during 1976–79, the share was larger, 44½ percent to 45½ percent; the relative decline since then was reflected, in part, in net lending. Considerable changes took place in the size of individual expenditure categories. The share of expenditure on goods and services, which was more than 19 percent of total expenditure in 1972, had dropped to 16 percent by 1980, but increased to 17½ percent in 1982. Within this category wages and salaries also declined from 11 percent of the total to just under 9 percent. Both expenditure items also declined as a proportion of GDP. Interest payments on the government debt, on the other hand, rose sharply from 2½ percent of total expenditure in 1972 to 6 percent in 1982.

The share of subsidies and other current transfers in the total rose slightly over the period, reaching 63½ percent in 1982. The fastest growing elements were transfers to households and subsidies to support traditional industries, especially those exposed to foreign competition, and also to cushion the impact of structural change resulting from the rapid development of the oil and gas sector.

Capital expenditure, at 4½ percent in 1982, had risen slightly over the period. Net lending, on the other hand, declined as a proportion of total expenditure from 12 percent to 8½ percent between 1972 and 1982. However, this decline conceals the rapid growth of this category during the first half of the period; in 1976 its share was as high as 16 percent, reflecting the importance of central government loans to state banks, especially for housing, as part of the countercyclical fiscal policy.

REVENUE

Central government revenue rose from the equivalent of 38 percent of GDP in 1972 to 42½ percent in 1982, which, after the Netherlands and

Belgium, is the third highest ratio among the smaller industrial countries. This rise is accounted for largely by income taxes whose share in total revenue rose from 21½ percent in 1972 to 27 percent in 1982. The rise in revenue from income taxes derives largely from the corporate tax whose share in income taxes soared from 7 percent to 63 percent as a result of the rapid development of the oil sector. In fact, excluding the corporate income tax, revenue from the remaining sources taken together grew at a slower pace than GDP. The personal income tax declined as a proportion of total revenue from 20 percent to 10 percent over the period. Social security contributions increased sharply from 20 percent to 27 percent of the total in the 1972–75 period, but have since been on the decline and were 22½ percent in 1982. The decline reflects successive reductions in the rates of these taxes, usually associated with the implementation of incomes policy.

The share of taxes on goods and services in the total declined from 46 percent to 37½ percent over the period, which implies a slower growth rate than that of GDP. More than half the revenue in this category is derived from a value-added tax, the remainder comprising various excise taxes and duties. Nontax revenue and grants account for about 10 percent of total revenue and remained a relatively stable proportion during the period. The most significant items are property income and administrative fees and charges. Other revenue sources, that is, property taxes, taxes on international trade, and other taxes ranged between 2 percent and 3 percent of total revenue in most years.

THE FISCAL BALANCE AND ITS FINANCING

As already noted, the consolidated central government finances registered deficits in every year of the period, except 1981 and 1982, despite substantial surpluses of the social security system, especially in the early part of the period. The deficits widened to 6 percent to 7 percent of GDP in the 1976–79 period when an expansionary fiscal policy was pursued to counteract the impact of external impulses on employment and living standards. In 1980 the deficit dropped sharply to 2 percent of GDP, largely as a result of rapidly rising oil tax revenues, and surpluses of 2 percent and 1 percent were registered in 1981 and 1982, respectively. Data on the consolidated central government represent the overall cash deficit, but for a country like Norway where revenue from exported oil and other external transactions is significant, the domestic budget balance concept is important, especially for estimating the monetary impact of government operations. Estimates of the domestic

budget balance are not available, but approximations that have been made by excluding oil tax revenue indicate that the domestic deficit is substantially larger than the unadjusted deficit and was probably 6 percent to 7 percent of mainland GDP in the last years of the period.

Sources of financing the fiscal deficit varied substantially over the period. From 1972–74 no recourse was had to external borrowing, but for the next five years, such financing frequently covered a large proportion of the financing requirement; in 1980 a policy decision was taken to cease foreign borrowing for this purpose. Financing by the monetary authorities took place in the 1975–78 period, especially in the first two years when about 20 percent of the deficit was financed in this way. Other domestic financing has fallen largely on deposit money banks, but also on the general public through bond sales. Central government debt, expressed as a percentage of GDP, rose from 28 percent to 42 percent from 1972 to 1979, but dropped to 26½ percent in 1982. The external component of the debt was 22½ percent of total debt in 1982, compared with 6 percent in 1972.

FISCAL POLICY

The framework. Norway has a relatively large local government sector. In 1982 when central government expenditure was equivalent to 42 percent of GDP, the ratio of general government expenditure was 53 percent. However, the budget of the Central Government plays a dominant role in public sector activity and, in addition, the Central Government has at its disposal certain powerful instruments to promote fiscal policy objectives. One is through its influence on local government activity. Thus, about one fourth of total local government revenue and grants, based on 1979 data, is derived from central government transfers; and the significance of these transfers has risen even further since then. Also, the Central Government is empowered to establish a maximum rate for the local income tax, which accounts for over 40 percent of total local government revenue and grants. Moreover, the Central Government, in principle, supervises borrowing by local authorities whose finances in the past several years of the period registered deficits equivalent to about 1 percent of GDP annually. Also relevant is the importance of state banks in furthering certain fiscal objectives. A major part of their operation is the financing of projects, such as housing investment, which is specifically conceived as an instrument of employment support. Lending by state banks is in part financed by direct government loans.

Fiscal policy is formulated on the basis of a comprehensive forecast of the economy for the upcoming year—the national budget—which was initiated as early as 1947. This document states the major objectives of economic policy and is presented to Parliament annually, where it is discussed along with the ordinary budget. A revised national budget is customarily presented in the course of the fiscal year and may lead to adjustments in the government budget. Longer-term considerations have been a significant determinant of fiscal policy and economic policy in general.

Long-term programs covering four-year periods were once presented to Parliament. These programs, which date back to 1948, set forth prospects for major national expenditure and production components and served as a basis for discussing medium-term resource allocation problems and stabilization policy issues. They did not, however, constitute expenditure commitments on the part of the Government. The link between annual budgeting and the long-term programs appears to have weakened over time, and recently, the long-term programming exercises were discontinued.

Lastly, although more in the realm of monetary policy, the annual credit budgets also have fiscal policy implications, as they incorporate the significant financial operations of the Central Government that are channeled chiefly through the state banks. The credit budgets, which were initiated in 1965, seek to secure consistency between the financial and real sides of the economy and attempt, more particularly, to quantify the volume and allocation of credit that would be consistent with macroeconomic objectives.

Aims and measures. The maintenance of full employment was an overriding aim of fiscal policy throughout the period. Another priority objective was the continued improvement of social benefits that had been developed at a rapid pace during the 1960s. Fiscal measures were also applied intensely to moderate cost and price pressures in the framework of tripartite incomes settlements. The fiscal content in this incomes policy approach also served the separate policy aim of redistributing income in favor of lower income groups. An additional role assigned to fiscal policy was to cushion the impact of structural change caused by the world recession and the rapid development of the oil sector by way of granting support to the sectors hardest hit.

All these objectives implied a highly expansionary fiscal policy, which to a certain extent was perceived as justified by the prospect of large future oil revenue. As a result, the fiscal deficit widened sharply

between 1973 and 1978. This widening was associated with high inflation rates and increasing current external deficits, and there was growing recognition that a shift to a less expansionary direction was needed to counteract the growing imbalances in the economy. The scope for an appropriate redirection of fiscal policy was limited, however, as the maintenance of full employment continued to enjoy a high priority as did the interaction of fiscal and incomes policies, which entailed high budgetary costs. Toward the end of the period, the effects of efforts to tighten fiscal policy as set out in the original budget tended to be reduced subsequently by employment-supporting measures, improvements in social benefits, and by tax reductions granted in the context of incomes policy.

In the mid-1970s, as it became apparent that the adverse impact of the oil crisis would extend to real growth and employment in addition to prices, the fiscal policy reaction was to stimulate demand. As investment demand was already high, the main emphasis was placed on giving a boost to private consumption. Measures introduced for this purpose included income tax reductions favoring lower income groups, increases in family allowances, consumer subsidies, pensions, and other social benefits, in particular the introduction in 1978 of a sick-pay scheme.

Similar measures were repeated in subsequent years, along with other measures that specifically aimed at sustaining employment, including public construction programs, lending at concessional terms for housing through the state banks, a stock-financing scheme whereby firms received subsidies to cover a certain proportion of the increase in stocks on the condition that employment was not reduced, wage cost subsidies in the textile industry, and retraining facilities. Also, as a means of sustaining employment in separate parts of the country, employers' social security contributions were differentiated by regions.

As indicated earlier, incomes policy is a prominent aspect of overall economic policy in Norway and fiscal policy has been closely connected with it. The general demand-stimulating measures noted above, that is, income tax reductions, increased social benefits, and consumer subsidies, are typical fiscal measures incorporated in successive incomes settlements; other measures of this type include increased agricultural subsidies resulting from the raising of farm incomes, reductions in employers' social security contributions, and increased tax deductibility for trade union membership fees.

Government support to industry has increased over the period and is closely related to the full employment objective. The main recipients of industrial subsidies are state-owned companies and the shipping industry. The specific forms these subsidies take include direct grants for specific purposes, reduced fees for the use of energy, direct wage subsidies, and various financial support schemes and loan guarantees. As indicated earlier, industrial subsidies are to a large extent selective and are designed to cushion the impact of structural change on the exposed sector and to promote regional policy.

Specific measures to implement a medium-term tax reform have been under preparation since such a reform was announced in 1977, and some were initiated toward the end of the period under review. The main objective is to reduce the adverse impact of high taxation on income distribution, savings, and work effort. As already noted, Norway has one of the highest tax ratios among industrial countries, and the income tax progression is quite steep. Marginal taxes range between 30 percent and 70 percent, with about one third of the taxpayers facing a marginal tax of 50 percent or more. The proposed measures include reduced progression of personal income taxes at the lower income steps, simplified deduction rules, increased taxation of higher incomes, and an increased share of indirect taxes. The Government that took office in 1981 announced in a medium-term policy strategy its intention to reduce the tax burden on both households and enterprises. To prevent the domestic budget deficit from widening, determined efforts were to be made to reduce public expenditure growth.

Overview and implications for future policy. Since the onset of the first oil crisis, fiscal policy in Norway has contributed significantly to the fair amount of success that has been achieved in dampening the adverse impact of external recessionary trends on economic activity and employment. However, this achievement has implied a persistent expansionary stance, whose sustainability was based on the prospect of large future oil revenues. While the expansionary policy kept up employment in a general way, the full employment policy also incorporated selective measures favoring industries exposed to foreign competition, other than oil. In an environment of a vast structural change, the selective employment-supporting policy, which was also highly motivated by socio-regional considerations, evidently retarded an adjustment that would have otherwise taken fuller advantage of the country's production potential. More specifically, the extent of support under this policy

obstructed labor mobility and limited the scope for structural adjustment. This problem is likely to remain a major consideration in the formulation of future fiscal and other economic policies.

The extensive application of fiscal measures to moderate wage settlements and reduce inflation appears to have enjoyed more limited success, although it is, of course, difficult to separate out the fiscal impact in this complex issue. In any case, the incomes policy-oriented fiscal measures contributed to the fiscal deficit, while the rate of inflation remained high. On the other hand, within the incomes policy approach, substantial progress was achieved in the stated policy aim of redistributing income in favor of middle- and lower-income groups.

At times in the past, the expansionary fiscal policy created problems for monetary policy, the scope of which is restricted by the government-dominated lending operations of the state banks, which, together with the domestic budget deficits, were a major cause of money supply growth. As a result, difficulties were encountered in covering the Central Government's borrowing requirement by noninflationary means. Reducing the domestic budget deficit is likely to become an important element in the strategy to bring inflation under better control. Insofar as the prospective tax reform entails a net loss of revenue, the announced efforts to limit expenditure growth will assume enhanced significance in this context.

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Spain

From the 1960s until the mid-1970s, the Spanish economy experienced faster economic growth than most industrial countries. In the 1972–74 period, average annual GDP growth exceeded 7 percent, but economic stagnation subsequently set in, with annual GDP growth rates averaging about 1½ percent. Spain's external sector is, along with Australia's, the smallest of the smaller industrial countries, with exports and imports, excluding services, equivalent to 12 percent and 18 percent of GDP, respectively, in 1982. Despite the smallness of the external sector, the impact of the first oil crisis was nevertheless substantial, as domestic energy production was quite limited. The ensuing slowdown in world tourism also harmed the economy. The stagnation of the economy was also the result of domestic developments such as excessive increases in real wages and a heavy burden on the enterprise sector imposed by high social security contributions, both of which contributed significantly to a marked deterioration of the environment for business activity. Other contributors included marked rigidities in production processes and the financial system and a failure to adjust energy prices to international levels.

The economic slowdown was accompanied by a substantial increase in the rate of unemployment which, after having ranged between 2½ percent and 3 percent of the labor force in 1972–74, rose steadily from 3½ percent in 1975 to 16 percent in 1982. The unemployment problem was accentuated by a reversal of migratory flows owing to poor labor market conditions in host countries, and also by migration of labor from agriculture. The rate of inflation remained high throughout the period, rising from over 8½ percent in 1972 to 24½ percent in 1977; it abated

thereafter, partly as a result of improved industrial relations, falling to 14½ percent in 1982.

The external current account position fluctuated over the period and caused growing concern in the post-1979 period when deficits between 2 percent to 2½ percent of GDP were experienced. Fiscal deficits, which were experienced in every year of the period, widened in the last years of the period, reaching 4½ percent of GDP in 1980. The deterioration in the fiscal position, while partly resulting from depressed cyclical conditions, was accentuated by an active policy to improve the social security system.

EXPENDITURE

Expressed as a ratio to GDP, central government expenditure rose from 20½ percent to 32½ percent between 1972 and 1981. Most of this expansion took place after 1976, reflecting the official policy to improve and extend the social security system and, to a lesser extent, increased employment costs in government service and increased net lending. The share of expenditure on goods and services in total expenditure declined from 43½ percent to 36 percent over the period, although wages and salaries, which account for about two thirds of expenditure in this category, kept pace with total expenditure growth in most years.

Subsidies and other current transfers increased their share in the total from 35½ percent to 42 percent, which accounted for more than half the increase in the ratio of total expenditure to GDP. Apart from social security expenditure, including unemployment compensations, measures to support employment and private sector activity and to cover losses by public enterprises entailed substantial expenditure increases. Interest payments on government debt remained around 2 percent of total expenditure throughout the period.

Capital expenditure was 14½ percent of the total in 1972 and played a significant role in endeavors to sustain employment. By 1981 its share in total expenditure had declined to 10½ percent, which nonetheless implies an almost constant share in GDP. Rapid growth of current expenditure pre-empted further use of this instrument for stimulating activity and employment, as measures to restrain the deficit frequently involved postponement of capital expenditure. Net lending, on the other hand, rose as a share of total expenditure from 3½ percent to 11½ percent during 1972–81. This rise reflected measures to support investment and economic activity through financial intermediation by the

Spain: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	8.1	7.9	5.7	1.1	3.0	3.3	1.8	0.2	1.5	0.4	0.9
Rate of unemployment	3.1	2.5	2.6	3.7	4.7	5.2	6.9	8.5	11.2	14.0	15.9
Consumer prices, percentage changes	8.3	11.4	15.7	16.9	17.7	24.5	19.8	15.7	15.5	14.6	14.4
External current account balance as percentage of GDP	1.2	0.6	−3.5	−3.0	−3.5	−1.8	0.9	0.3	−2.4	−2.4	−2.3

Source: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984.

Spain: Consolidated Central Government Finances, 1972–81

(Year ended December 31)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Total Revenue										
(as a percentage of GDP)	20.0	20.2	19.9	21.0	20.7	22.7	23.7	24.3	24.7	25.3
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	15.8	16.4	17.3	18.1	20.1	18.8	20.8	21.9	23.9	20.5
Social security contributions	38.8	39.7	41.2	44.5	43.0	47.4	47.9	48.2	47.0	47.2
Payroll (manpower) taxes	—	—	—	—	—	—	—	—	—	—
Property taxes	5.5	5.8	6.1	5.6	5.3	4.8	4.7	4.2	4.3	3.5
Taxes on goods and services	23.3	23.5	19.3	17.8	15.8	13.3	13.8	13.4	16.7	18.1
Taxes on international trade	9.9	10.3	9.6	9.0	10.9	11.0	8.5	8.7	6.0	5.8
Other taxes	0.4	0.4	0.4	0.3	0.4	0.3	0.3	0.4	0.4	0.6
Nontax revenue and grants	11.5	9.2	11.4	9.7	9.3	9.7	8.1	8.1	7.2	8.7
Total Expenditure										
(as a percentage of GDP)	20.5	20.4	21.1	22.7	21.6	24.9	26.0	27.8	29.0	32.3
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	43.3	44.8	43.0	42.0	45.6	42.1	42.8	37.2	42.1	35.9
Of which:										
Wages and salaries	28.0	28.1	27.3	26.6	30.1	28.8	28.8	28.8	29.4	25.7
Interest payments	2.3	2.7	2.0	1.7	1.6	1.6	1.7	1.8	1.9	1.7

Subsidies and other current transfers	35.3	36.3	36.3	36.4	37.0	37.6	42.9	47.8	42.6	41.9
Of which:										
Social security funds	24.6	25.9	25.5	25.9	26.7	27.7	30.8	35.2	32.8	34.0
Capital expenditure	14.7	13.1	12.7	12.5	12.2	13.2	10.8	9.3	9.9	10.7
Lending minus repayments	3.7	3.5	6.1	8.5	3.5	8.0	5.9	6.4	6.6	11.3
Surplus/Deficit (as a percentage of GDP)	−0.5	−0.3	−1.2	−1.8	−0.9	−2.2	−2.4	−3.5	−4.3	−7.1
Financing:										
Abroad	—	—	0.1	—	0.4	0.9	−0.4	—	−0.1	0.3
Domestic	0.6	0.2	1.1	1.8	0.5	1.2	2.8	3.6	4.4	6.8
Monetary authorities	−0.4	0.1	0.8	0.9	−0.4	0.2	1.0	1.1	2.3	2.6
Deposit money banks	...	...	...	...	...	...	...	...	...	...
Other[1]	...	...	...	...	...	...	...	...	...	...
Memorandum Items:										
General government expenditure and net lending/GDP	21.6	21.6	22.3	24.2	23.6	26.9	28.0	29.4	31.1	35.2
Central government debt outstanding/GDP	15.6	13.2	11.8	12.1	13.0	15.3	14.3	15.4	17.2	19.4

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.
Note: Adjustments to total revenue and expenditure cause the totals to exceed 100 percent in most years.
[1] Includes adjustments.

Government, which directs finance to official credit institutions and state-controlled agencies through the budget.

REVENUE

Total central government revenue increased as a proportion of GDP from 20 percent to 25½ percent during the 1972–81 period, which is substantially less than the growth of expenditure. Two types of tax, social security contributions and income taxes, accounted entirely for this rise, while the share of all other tax categories in total revenue declined. The increase in revenue from the most significant indirect taxes and from nontax sources did not keep pace with GDP growth. Social security contributions are by far the largest revenue source. Their share in total revenue rose from 39 percent in 1972 to 47 percent in 1981, after having exceeded 48 percent two years before. The ratio is the highest of any of the smaller industrial countries, although not when measured as a proportion of GDP, since Spain's central government sector is the second smallest among these countries. About 80 percent of social security contributions are borne by employers.

Income taxes increased their share in total revenue from 16 percent to 20½ percent over the period, despite a series of reductions designed to redistribute income in favor of the lower income groups and to dampen wage claims. Taken together, income taxes and social security contributions accounted for almost 68 percent of total central government revenue in 1981. Domestic taxes on goods and services, largely excises, turnover tax, and profits of fiscal monopolies, declined in relative importance from 23½ percent of total revenue in 1972 to 18 percent in 1981. Taxes on international trade likewise underwent a relative decline from 10 percent to 6 percent between 1972 and 1981, as did nontax revenue whose share in the total declined from 11½ percent to 8½ percent. This revenue category consists mainly of property income and administrative fees and charges. The share of property taxes shrank from 5½ percent to 3½ percent, and other taxes remained a steady ½ of 1 percent of the total over the period.

THE FISCAL BALANCE AND ITS FINANCING

The central government finances recorded deficits in every year of the period covered. Until 1977, these ranged from ½ of 1 percent to just under 2 percent of GDP, but subsequently they widened every year and reached 7 percent of GDP in 1981. Major factors contributing to this

development were increases in social security benefits and extension of their coverage, growth of unemployment compensations, and subsidies to the enterprise sector resulting from depressed cyclical conditions that also retarded revenue growth. In the early years of the period, borrowing from the domestic nonbank sector exceeded the requirement for financing the central government deficit, as fiscal policy was pursued to support monetary policy in reducing overall liquidity in the economy. The role of the Treasury in this respect was reversed later in the period and recourse was had to the central bank in most years after 1974; from 1978 such monetary financing covered one third to one half of the deficit. The Central Government's recourse to short-term credit from the central bank is restricted to 12 percent of budgetary expenditures and those of autonomous agencies. In 1976 and 1977 the financing requirement was partly met by external borrowing, which was also resorted to in 1974. Domestic financing through the deposit money banks and the general public varied considerably during the period, but usually these sources financed a substantial portion of the central government deficit, especially commercial bank financing. Because of the series of surpluses experienced in the 1960s, associated in part with the buildup of social security funds, total central government debt, expressed as a proportion of GDP, was a moderate 19½ percent in 1981, having risen only slightly from 15½ percent since 1972 as a result of inflation. External debt was about 5 percent of total debt in 1981, compared with 5½ percent in 1972.

FISCAL POLICY

The framework. The central government sector dominates public sector activity in Spain. Total expenditure of the Central Government is about 32 percent of GDP according to 1981 data; general government expenditure was 35 percent in that year. These ratios imply a smaller local government sector than in any other country in the group. Apart from own taxes, local governments rely on central government transfers under a revenue-sharing arrangement. At present, however, a movement toward regional decentralization is in progress, which has caused a deterioration in local government finances, because their revenue-raising capability has not kept pace with expenditure growth. Borrowing by local governments is subject to approval of a council composed of central and local government representatives.

A special feature of the budgetary process is the authority vested in the executive branch to implement expenditure beyond budgetary limits

in the course of the fiscal year. While the budget is generally subject to ordinary legislative procedures, the Ministry of Finance may authorize excess expenditure up to 2 percent of appropriations in the budget, and the Council of Ministers may authorize up to 5 percent of budgetary expenditures for autonomous agencies and 10 percent for public enterprises. This authority provides for a substantial measure of flexibility in fiscal policy. Moreover, beginning in 1974 and continuing for a few years, budgetary appropriations were made to a short-term intervention fund that was activated in response to cyclical conditions.

Four-year development plans were initiated in 1964, and four such plans covering the period to 1980 were prepared. However, on account of political uncertainties, the 1976–80 plan was never debated in Parliament. The plans were not comprehensive and their ties to the budget were only partial; they were more or less confined to the public investment program. A new government prepared a more comprehensive economic program in 1977, as well as another medium-term program in 1979 stating its policy in general and incorporating specific economic targets. Program budgeting was promoted in an effort to link expenditure more explicitly to specific policy objectives, and zero-based budgeting is reported to have been applied to half the expenditure in the 1980 budget.

The role of the Central Government as a financial intermediary has been growing over the period. Funds obtained from the banking sector through captive arrangements are channeled through the budget to official credit institutions, which in turn provide concessional financing of medium- and long-term investment in priority sectors in line with official policy.

Aims and measures. In the early years of the period, fiscal policy was pursued flexibly for general demand management purposes. The initial response to the energy crisis was to redirect fiscal policy to an expansionary stance, and in early 1974 substantial stimulative measures were introduced. In the following year, a worsening balance of payments position and rising inflation rates led the authorities to revert to a more restrictive stance. During 1976 fiscal policy was relatively inactive, as was economic policy in general, as the authorities gave priority to the task of ensuring a smooth political and organizational transition.

The government that assumed office in 1977 announced late in that year a comprehensive economic program based on a wide political consensus. The program aimed at reducing the imbalances in the economy that had developed in the preceding period of slack economic

management. The role assigned to fiscal policy was to provide stimulus to employment and activity through selective measures, while containing the fiscal deficit so as not to jeopardize the aims of reducing the current external deficit and inflation, which were to be achieved mainly through a restrictive monetary policy stance. The stage was also set for a comprehensive tax reform, with a view to making the system more efficient and equitable. A reform of the social security system was also announced. A basic aim underlying these reforms was to redistribute income in favor of lower income groups.

Measures to promote income redistribution in line with government policy were far-reaching. The income tax reform involved a replacement of the previous proportional schedular system with a general progressive personal income tax and a corporate tax. A wealth tax was also introduced. Moreover, minimum taxable income was raised in line with inflation, along with reductions of taxes on basic foodstuffs and the introduction of special taxes on luxury goods. Reform of the social security system was another major aspect of income redistribution policy concerns.

The 1977 policy announcement followed several years of substantial increases in social benefits and extensions of their coverage, especially pensions and unemployment compensation. In 1971 the system had been extended to farm workers and self-employed in agriculture, and in the following year contributions were linked to actual earnings instead of the legal minimum wage, a change that favored low-income earners. Basic reforms of the system have been slow to materialize, however. Some of the tax reductions noted above also served the purpose of dampening price increases and, as was the case in 1976, of making the continuation of wage controls more acceptable. Increases in price subsidies of consumer goods served similar purposes.

The policy of stimulating employment and economic activity largely relied on increases in public investment, both directly and through financial intermediation. While the former approach lost some of its relative significance over the period, as already noted, redirecting finance from the banking sector to official credit institutions to foster priority investments assumed an enhanced role in the budget. Other measures to promote this policy objective include tax incentives for exports and for investment in depressed regions, a commitment in a 1981 tripartite agreement to promote the creation of a certain number of jobs against wage restraint, and a commitment to reverse the trend of the constantly increasing burden of social security contributions on labor costs.

Overview and implications for future policy. For most of the 1970s, fiscal policy in Spain was directed at two basic aims: redistribution of income in favor of low-income earners, and stimulation of employment and activity. This policy was constrained by the need to contain the fiscal deficit in order to avoid undue pressure from central government transactions on prices and the external current account. Action in these areas was in large measure assigned to other economic policies, and in the latter half of the period, to monetary policy in particular.

Following the economic program in 1977, progress was made in reforming the income tax system, and indirect taxes were changed to pave the way for a value-added tax. Social security contributions grew sharply with a concomitant increase in wage costs. Thus, from 1973 to 1980, these contributions rose from 16 percent to 25 percent of the total wage bill. This development is likely to have distorted factor costs against labor, which is especially detrimental in a country faced with a serious unemployment problem. The equitable properties of the social security system have not evolved in line with the sharp increase in benefits. In particular, there is a lack of standardization of benefits and contributions, as well as an element of sectoral, age, and sex discrimination.

These shortcomings of the social security system and its negative impact on labor costs pose one of the major problems facing fiscal policy at present. The authorities recognized the need for improvement in the 1977 economic program, but progress has been slow. However, concrete proposals for a basic reform of the system are being considered for implementation with the introduction of a value-added tax, currently envisaged for 1986, that is expected to yield the required additional revenue to contain the financial deterioration of the system.

Despite persistent fiscal deficits, they were relatively low; also, as a result of inflation, total debt of the Central Government was moderate at the end of the period. Monetary financing of the deficits, on the other hand, was high and imposed a strain on monetary policy, which is the major instrument of short-term demand management. An undue restriction of domestic credit to the private sector might result from a continuation of such financing.[1]

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[1] Since 1981 fiscal developments have changed in many respects. Most notably, the relative significance of income taxes and social security contributions has been reduced, while reliance on indirect taxes and government transfers to finance social security expenditure has increased. Moreover, government borrowing at market rates has increased substantially, and a market for treasury bills has been introduced.

13

Sweden

The growth performance of the Swedish economy was moderate over the period covered. In 1974 and 1975 the policy response to the oil price increases was to strengthen the expansionary fiscal stance in order to preserve a high level of employment, which traditionally is assigned the highest priority in Swedish economic policy. Real GDP grew by 3 percent and 2½ percent, respectively, in 1974 and 1975; these are among the highest growth rates attained by any country in the group in these years. Subsequently, except in 1979 when real GDP rose by almost 4 percent, economic growth was sluggish or negative, despite continued expansionary fiscal policy. Apart from unfavorable external conditions, this experience has been attributed, in part, to fiscal measures designed to attain various social objectives, but which have at the same time squeezed industrial profits, reduced labor mobility, and retarded structural adjustment.

The rate of unemployment remained low by international standards throughout the period as a result of extensive fiscal measures affecting the labor market; however, it rose to 2½ percent and 3 percent, respectively, in 1981 and 1982—historically high rates for Sweden.

Inflation ranged from 6 percent to 13½ percent during the period and in most years since the 1974 oil price explosion was around 10 percent, which is in the upper range among industrial countries. During the last two years of the period, the rate of inflation abated, however, and was 8½ percent in 1982.

The external current account, which had traditionally been in balance over a full business cycle, went into deficit in 1974 and remained so for the rest of the period, reaching a high of 3½ percent of GDP in 1982. Inflation and external current account deficits were associated with

large and growing fiscal deficits at the central level; in 1978, the overall public sector balance swung into deficit, which grew each year, reaching over 7 percent of GDP in 1982.

EXPENDITURE

From 1972 to 1982, central government expenditure as a proportion of GDP expanded by almost 14 percentage points to 49 percent, one of the largest increases experienced among the smaller industrial countries during this period. Besides the automatic reaction of the budget to slower economic growth, two main factors contributed to this expansion, which took place mostly from 1976. First, subsidies and other current transfers, notably vastly increased social security outlays in various forms, steadily increased their share in total expenditure from 50 to 66 percent. These increases largely reflect deliberate policies to extend social security and to improve real benefits, such as pensions, which increased particularly rapidly because of automatic adjustments for inflation, reduction of the general retirement age in 1976, and the introduction of a flexible retirement option, also in 1976. Also, transfers to other levels of government have been growing as has aid to ailing industries. Second, interest payments on government debt rose as a share of total expenditure from just under 3 percent in 1972 to 9½ percent in 1982, as a result of fiscal deficits that were registered in every year of the period. The share of other expenditure categories in total expenditure declined, although not necessarily their share in GDP. Thus, expenditure on goods and services, while declining as a proportion of total expenditure from 21 percent to 14 percent, slightly increased as a proportion of GDP at around 7 percent. Capital expenditure and net lending, on the other hand, declined as a proportion of GDP, especially in the latter half of the period. Both types of expenditure were nevertheless relied on to keep up employment, both as direct capital outlays on relief work and related activities, and as concessional lending for house construction and to ailing industries.

REVENUE

Revenue as a proportion of GDP rose by 5 percentage points to 39 percent in 1982. This expansion all took place from 1976 onward, and particularly in 1976 when the share underwent an upward shift of more than 4 percentage points from the base year. Characteristic of revenue developments during the period was the rapid increase in social security contributions, which were borne increasingly by employers. As a

Sweden: Selected Economic Indicators, 1972–82

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Real GDP, percentage changes	2.3	4.0	3.2	2.6	1.1	−1.6	1.8	3.8	1.7	−0.5	0.4
Rate of unemployment	2.7	2.5	2.0	1.6	1.6	1.8	2.2	2.1	2.0	2.5	3.1
Consumer prices, percentage changes	6.0	6.7	9.9	9.8	10.3	11.4	10.0	7.2	13.7	12.1	8.6
External current account balance as percentage of GDP	1.3	2.8	−1.0	−0.5	−2.1	−2.6	0.0	−2.2	−3.6	−2.5	−3.6

Source: Organization for Economic Cooperation and Development, *Economic Outlook*, December 1984.

Sweden: Consolidated Central Government Finances, 1972–82

(Year ended June 30)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Total Revenue											
(as a percentage of GDP)	34.1	32.8	32.8	33.7	38.3	39.6	39.5	38.1	37.8	38.9	39.0
Percentages of total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income taxes	26.8	22.7	21.6	21.4	25.1	23.5	18.7	18.3	18.1	15.9	15.5
Social security contributions	21.5	22.1	23.6	26.7	26.6	27.8	30.9	32.3	32.8	34.7	33.7
Payroll (manpower) taxes	3.0	4.4	5.9	5.9	5.9	6.4	6.2	3.3	3.1	3.8	3.3
Property taxes	1.6	1.6	1.5	1.3	1.3	1.2	1.1	1.1	1.2	1.1	1.2
Taxes on goods and services	33.8	34.5	32.8	29.9	27.5	27.5	28.8	29.8	29.0	29.6	29.4
Taxes on international trade	1.4	1.4	1.3	1.9	1.5	1.5	1.1	1.1	1.1	1.2	0.6
Other taxes	0.1	0.1	0.1	0.1	—	—	0.1	0.1	0.1	—	0.1
Nontax revenue and grants	11.8	13.2	13.2	12.8	12.0	12.1	13.1	14.1	14.5	13.7	16.3
Total Expenditure											
(as a percentage of GDP)	35.4	34.2	36.1	36.4	38.7	41.3	44.8	45.7	46.5	48.3	48.9
Percentages of total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expenditure on goods and services	20.8	21.2	20.1	19.8	18.2	17.2	16.3	16.2	15.8	14.9	14.0
Of which:											
Wages and salaries	10.5	10.3	9.5	9.1	8.7	8.2	8.0	7.6	7.3	6.7	6.4
Interest payments	2.9	3.1	3.1	3.7	3.3	3.7	4.0	4.4	6.3	9.0	9.5

Subsidies and other current transfers	50.2	53.2	55.6	57.5	60.1	62.4	63.7	65.8	64.5	64.6	66.0
Of which:											
Social security funds	3.6	4.3	4.8	5.1	5.4	6.4	7.1	7.8	8.3	8.8	9.7
Capital expenditure	8.7	8.5	7.0	6.5	6.1	6.4	5.4	5.1	4.2	4.0	3.6
Lending minus repayments	17.4	14.0	14.2	12.5	12.3	10.3	10.7	8.5	9.1	7.5	6.9
Surplus/Deficit (as a percentage of GDP)	−1.3	−1.5	−3.3	−2.7	−0.4	−1.7	−5.2	−7.6	−8.7	−9.4	−9.9
Financing:											
Abroad	—	—	—	—	—	1.4	1.6	0.8	3.5	2.7	2.6
Domestic	1.3	1.5	3.3	2.7	0.3	0.3	3.7	6.8	5.2	6.7	7.2
Monetary authorities	1.1	−1.0	1.0	2.5	−2.7	−0.3	0.6	0.9	2.2	1.9	3.5
Deposit money banks	0.9	1.3	0.8	−0.2	1.5	−0.8	1.9	3.6	0.7	3.0	2.2
Other[1]	−0.7	1.2	1.5	0.3	1.4	1.5	1.2	2.2	2.4	1.8	1.5
Memorandum Items:											
General government expenditure and net lending/GDP	51.7	49.5	51.6	52.2	54.2	58.1	62.2	62.7	64.5	66.2	71.2
Central government debt outstanding/GDP	16.6	16.7	18.3	18.9	17.0	18.3	21.3	25.7	32.3	38.8	45.4

Source: International Monetary Fund, *Government Finance Statistics Yearbook*, 1983 and 1984.
[1] Includes adjustments.

proportion of total revenue, these contributions increased from 21½ percent to 33½ percent between 1972 and 1982. A substantial relative decline in the share of income taxes took place over the period, from 27 percent in 1972 to 15½ percent in 1982; the decline reflected a policy to reduce the detrimental impact of extremely high marginal rates on work effort, the indexation since the beginning of 1979 of income tax scales and the basic deduction, and an effort to moderate contractual wage increases through income tax reductions. The personal income tax rates, however, are still among the most progressive in industrial countries. The highest marginal rate was 85 percent at the end of the period.

Taxes on goods and services declined as a share of total revenue from 34 percent in 1972 to 29½ percent in 1982, while their ratio to GDP remained constant. More than half the revenue in this category is derived from a value-added tax whose share rose over the period, whereas the remaining taxes on goods and services, mostly excises, declined in relative importance. The share of nontax revenue in the total ranged from 12 percent to 16½ percent over the period. This revenue is mostly in the form of property income from nonfinancial public enterprises and capital funds. Other revenue sources were less significant and changed little over the period.

THE FISCAL BALANCE AND ITS FINANCING

Fiscal deficits were experienced every year since 1972, and since 1976 these grew rapidly, amounting to 10 percent of GDP in 1982. As indicated earlier, this development is the result of a variety of factors, including the Government's commitment to full employment, improvement and extension of social benefits, incomes policy measures by way of tax reductions, an environment of poor growth performance in the latter half of the period with adverse repercussions on both sides of the budget, and the ensuing increase in interest payments on government debt. It should be noted in this context that the financial balance of the public sector as a whole is substantially better than the central government balance. Mainly on account of a buildup of the National Pension Fund, the public sector showed a surplus until 1978 but experienced growing deficits thereafter, due to the sharp deterioration in the central government's financial position. The local government finances remained in approximate balance. The overall public sector deficit exceeded 7 percent of GDP in 1982, compared with a central government deficit of 10 percent in that year.

From 1972 to 1976 the fiscal deficit was financed entirely by domestic resources, that is, borrowing on the capital market and from the banking system, while borrowing from the monetary authorities in one year tended to be repaid in the following year. From 1977 recourse was had to external borrowing and domestic monetary financing, while domestic nonbank sources covered a declining portion of the central government deficits, posing problems for monetary policy, as explained in the following section. The mounting fiscal deficits entailed a sharp rise in government debt, which, as a proportion of GDP, increased from 16½ percent to 45½ percent between 1972 and 1982. The share of foreign debt in total central government debt rose from zero to 23 percent over the same period.

FISCAL POLICY

The framework. While the central government budget is the major instrument of fiscal policy in Sweden, other public entities are involved, which, especially in the earlier part of the period, were instrumental in the pursuit of countercyclical policy. In principle, local government budgets are required to be balanced and as such are not relied on for stabilization purposes. Of total general government expenditure, which was equivalent to 71 percent of GDP in 1982, the Central Government accounted for 49 percent, if transfers to other levels of government are included. These figures imply a large local government sector—indeed, the largest among the smaller industrial countries—reflecting the marked expansion of local government activity in the 1960s.

Although local governments enjoy a high degree of independence in their financial decisions, they can be influenced by the Central Government as far as certain types of taxation, expenditure, and borrowing decisions are concerned. Moreover, the Central Government makes agreements with local governments from time to time to coordinate actions for certain policy objectives, such as the maintenance of a high level of employment and the containment of taxation to limit the public sector's claims on resources and crowding out of the private sector. A special manifestation of such coordination in the early 1970s was the expansion in slack periods of subsidized housing investments, largely in apartments under municipal ownership or participation, in order to maintain high and stable employment. This policy instrument was not very effective in later years, however, as residential construction needs were gradually saturated.

Although the financing of the social security system is normally determined on a medium-term basis and thus does not play an active role in stabilization policy, the contribution rates are nonetheless subject to revisions when the Central Government's overall financial policy is formulated. As indicated earlier, financial surpluses of the social security system more than outweighed the central government deficits until 1978, but they have since shrunk, largely on account of an upsurge in benefits payments that were not matched by increases in contributions and transfers from the budget.

The operation of investment deposit funds is closely related to fiscal policy. Investment deposit funds are profits that enterprises may deposit free of corporate income tax with the central bank on non-interest-bearing investment deposit accounts. Such deposits, which may amount to 40 percent of the firm's annual profits, can be used for fixed investments whenever their release is permitted for certain cyclical or regional policy objectives. Otherwise, if they are used within a given period, the profits become subject to tax. A stockbuilding scheme with employment conditions attached to it also constituted a flexible instrument of fiscal policy, as noted below.

The annual budget documents contain an economic policy statement by the Government and a survey of the national economy. Multiyear budget estimates are also presented to Parliament. These estimates point out the implications of existing commitments and proposals for the various budget aggregates for the next five-year period and serve as a basis for ensuring consistency of sectoral resource allocation with political goals.[1] No formal decisions on the multiyear budget are taken by Parliament.

Since 1969, an estimate of the impact of certain budget components, as well as changes in the balances of investment deposit funds on the economy, has been published in the national budget. This attempt at measuring the fiscal impact on total demand and domestic production was made more elaborate in the 1974 budget with the adoption of a more disaggregated model that tried to take into account the different impact on the economy of different expenditure and revenue items. While likely to elucidate the relationship between the budget and the rest of the economy, the real impact of the model on fiscal decision making is uncertain, as is often the case with similar exercises.

[1] Eriksson, p. 68.

Aims and measures. Broadly expressed, the major objectives of fiscal policy over the period were the maintenance of full employment and the preservation of high living standards in the face of adverse external impulses on the economy. Special support was also given, especially in the latter half of the period, to traditional industries facing difficult structural adjustment problems. Moreover, tax policy was to some extent directed at moderating general wage settlements. The pursuit of fiscal policy toward these objectives was constrained, however, by persistent external current account deficits and high inflation rates.

Expecting the world recession following the sharp oil price increases in 1973 and 1974 to be short-lived, the authorities decided to pursue a traditional high-employment policy vigorously and applied fiscal policy measures extensively. These took various forms, the most direct including special construction programs, relief work, labor market training, temporary grants to industry and the services sector for the recruitment of additional employees, and increased local government absorption of the labor force, which was partly financed by transfer payments from the Central Government. The introduction in 1975 of a temporary stock-support scheme, whereby enterprises received grants of 20 percent of the volume increase in their inventories, was conditional upon the maintenance of employment levels by the enterprises over the relevant period, namely, through 1977. The absorption of employment by the public sector was more marked in Sweden than in most other industrial countries. Thus, between 1970 and 1978, the share of the government services sector in total employment rose from 20½ percent to almost 29 percent, compared with a rise from 12 percent to 14½ percent on the average in those industrial countries for which data are available.[2]

The continuous sharp increase in the outlays of the social security system was attributable to increased real benefits and extension of their coverage. The principal social security benefits are indexed to the cost of living. Also, demographic factors contributed strongly to the increases; in particular, the aging structure of the population had an important bearing on health expenditure. The social security system is to a large extent financed by employers' contributions. As a result, the overall

[2]Organization for Economic Cooperation and Development, *Economic Surveys: Sweden*, p. 42.

ratio of contributions to the total payroll has been as high as 34 percent to 35 percent in recent years, having risen from 14 percent in 1970. The strain on private sector activity was intensified by substantial wage increases in the mid-1970s.

To improve the unfavorable cost position of the economy, the authorities decided, inter alia, to eliminate the 4 percent general employers' fee in 1978, which reduced the overall rate by 1 percentage point, the first such reduction in the 1970s. Payroll taxes, however, were recently raised again. A more persistent effort by the Government was to create a favorable atmosphere for moderate wage settlements through incomes policy measures without direct involvement in the bargaining process. These included income tax reductions, which were also motivated by the perceived detrimental impact on work effort of very high marginal rates. Since 1979, the income tax brackets and the basic deduction have been indexed on the basis of consumer prices, with certain items in the index base excluded. Increased food subsidies have served a similar purpose.

To cushion the impact of structural change on ailing industries and thereby keep up domestic activity and employment, budgetary appropriations for industrial subsidies rose sharply in the latter half of the period. These were in the form of direct transfers to state enterprises and private enterprises in shipbuilding, steel, mining, and forest products industries. Industrial support measures were initially aimed at protecting employment in existing industries rather than stimulating new job outlets. With continued recessionary conditions, this kind of employment tended to become permanent, and by 1979 support to ailing industries had reached the equivalent of 5 percent of GDP. This policy stance was gradually shifted to support that was conditional upon restructuring. More recently, the improved profit situation resulting from the 1982 devaluation of the krona has resulted in a substantial reduction in industrial subsidies, and further reduction is planned.

Overview and implications for future policy. The automatic effects of the slowdown of economic activity and an expansionary fiscal policy pursued throughout the period entailed a sharp expansion of the central government sector; as local government also grew substantially, the public sector in Sweden reached the equivalent of about 71 percent of GDP in 1982—among the largest in industrial countries. The expansionary fiscal policy, while successful in maintaining a high level of employment and living standards, has widespread economic implications and poses difficult problems for future policy. It is felt that some of

the major measures, such as high unemployment and pension benefits, have stimulated consumption rather than industrial investment and, together with high and increasing payroll and other taxes, contributed to balance of payments difficulties and a severe retrenchment of resource availability to industry and the exposed sector. Large-scale support to ailing industries and employment schemes may have reduced labor mobility and retarded structural adjustment.

Rapid expenditure growth was accompanied by an increased tax burden, and, as Sweden's marginal tax rates are among the highest in industrial countries, this burden is likely to have affected work incentives adversely. To remedy the situation, a major reform of the personal income tax system is contemplated, according to which the highest marginal rate would be limited to 50 percent by 1985 for the majority of taxpayers. The revenue loss would be financed by an increase in payroll taxes and energy taxes, a reduction in the indexation of tax brackets, and a 50 percent ceiling on interest deductibility.

On the monetary side, the sharp rise in the Central Government's borrowing requirement exerted an upward pressure on interest rates, with an adverse impact on industrial investment, and seriously complicated the task of monetary management. To avoid crowding out industry from the capital market, the authorities endeavored to limit government borrowing outside the banks. This led to growing monetary financing of the fiscal deficit, accompanied by excessive monetary expansion. Nonetheless, private non-housing investment fell from 12 percent of GDP in the early 1970s to 8 percent in the years after 1978.

Owing to indexation and the automaticity of a growing share of expenditure due to previous spending commitments, budgetary policy has become increasingly inflexible. It is estimated that 80 percent of central government spending is determined by such automatic mechanisms and that over 50 percent of expenditure is automatically indexed.[3] Also, the authorities have been constrained in raising indirect taxes, due to the impact on prices and inflationary expectations.

A medium-term forecast of fiscal developments prepared in the early 1980s revealed that, assuming unchanged policies, the fiscal deficit was likely to remain at around 14 percent of GDP. The Swedish authorities declared this as unacceptable and adopted a policy to reverse past trends and restructure the public finances. In the light of an already high tax ratio, major emphasis would be placed on containing expendi-

[3] Eriksson, p. 70.

ture growth, inter alia, by reducing indexation. The 1982 devaluation created scope for a substantial reduction in industrial support through the budget, but at the time of writing other specific details of the above policy had not been worked out.[4]

[4]In 1983 and 1984, the expansionary stance of fiscal policy was reversed and the fiscal balance improved in both years. Among factors contributing to this development were increases in indirect taxes, limitations placed on deductions for income tax purposes, a reduced degree of indexation of tax brackets, and sharply reduced industrial subsidies and capital contributions to ailing industries.

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